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Lessons from the credit crunch

A special report on central banks and the world economy

PRINT EDITION

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Print Edition — October 20th 2007

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Central banks have worked miracles for the past quarter century. Don't count on that continuing: leader

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Politics this week

Oct 18th 2007
From The Economist print edition

Turkey's parliament voted to authorise a military incursion into northern Iraq, where many Kurdish PKK fighters are based. They have killed 20 Turkish soldiers in two weeks. Turkey's government promised that an invasion was not imminent, however. See article

Ukraine's "orange" coalition government was re-formed, following lengthy negotiations after the September 30th election. The likely prime minister will be Yulia Tymoshenko, who served in the job in 2005 before being sacked by her orange ally, President Viktor Yushchenko.

France was crippled by transport, electricity and gas strikes, staged in protest at President Nicolas Sarkozy's plans to end the "special regimes" that entrench generous pensions for these public-sector workers. Yet in contrast to 1995, when similar protests overturned an attempt to end the special regimes, the public seems to be on Mr Sarkozy's side, not the workers'. See article

AFP

In a landmark decision the **European Court of Justice** ruled that a mandatory retirement age may not be illegal, despite laws banning age discrimination in the workplace, so long as it promotes policies in the public interest, such as lowering unemployment.

Talking peace

After visiting **Israel** and the **Palestinian** West Bank, including Bethlehem, Condoleezza Rice, the American secretary of state, said that a conference to rekindle the Israeli-Palestinian peace process, planned for next month or December in America, stood a "reasonable chance of success", despite outstanding differences. But the Palestinian leader, Mahmoud Abbas, said he would not attend the conference "at any price".

A peace agreement signed in 2005 between south **Sudan** and the Sudanese government of President Omar al-Bashir was in danger of collapsing after the southern ministers walked out of the national unity government. Mr Bashir let the Sudan People's Liberation Movement, the main southern group, reshuffle its ministers, but it refused to rejoin the government unless the north implemented its side of the agreement on issues such as troop withdrawal and boundary demarcations. See article

The UN World Food Programme stopped distributing food in **Somalia's** embattled capital, Mogadishu, after its local head was abducted by government soldiers.

Reporters Without Borders, a lobby group, ranked **Eritrea** bottom in the world for overall press freedom in its annual study, below North Korea. Under President Issaias Afeworki's regime four journalists have died in detention.

The UN General Assembly elected Libya and Vietnam, along with Burkina Faso, Costa Rica and Croatia, to non-permanent seats on the **Security Council**. They take up the seats on January 1st.

Network call

On a visit to Cuba, Venezuela's left-wing president, Hugo Chávez, called for the two countries to form a **confederation**. Mr Chávez signed economic co-operation agreements, including a plan for a $1 billion petrochemical plant in Cuba. He also carried out a telephone interview, broadcast live, with Fidel Castro, the island's ailing president.

Canada's conservative minority government announced an ambitious programme for the new

parliamentary year, including tax cuts and environmental legislation, and promised to keep troops in Afghanistan beyond 2009. The Liberals, the main opposition, appeared unlikely to force an early election by voting against the programme. See article

In southern **Colombia**, a landslide triggered by local residents digging for rumoured gold deposits in an abandoned mine killed at least 21 people.

EPA

Opposition move

Benazir Bhutto, twice prime minister of **Pakistan**, returned home after eight years in exile, to the cheers of hundreds of thousands of her supporters in the Pakistan People's Party. General Pervez Musharraf had asked her to delay her return until the Supreme Court ruled whether his re-election to a new term as president was constitutional. See article

Manmohan Singh, **India's** prime minister, called George Bush to explain the difficulties he is having in implementing an agreement with America on civilian nuclear co-operation. India's Communist parties, whose support the government needs for a parliamentary majority, continue to oppose the deal. See article

Japan and the European Union both announced new sanctions against the military regime in **Myanmar**, which continued to round up those accused of backing protests last month. See article

John Howard, **Australia's** prime minister, called an election for November 24th, in the hope of winning a fifth term in office. Opinion polls give the main opposition Labor Party a comfortable lead. See article

China's ruling Communist Party opened its five-yearly congress with a speech from the party leader, President Hu Jintao. Although he used the word “democracy” some 60 times, he offered little hope of serious political reform. He surprised some observers by the mildness of his rebukes to Taiwan and America. See article

In **Hong Kong**, Donald Tsang, the chief executive, apologised after remarks in a radio broadcast linking democracy and China's tumultuous Cultural Revolution of the 1960s and 1970s.

China protested fiercely when the Dalai Lama, **Tibet's** exiled spiritual leader, was awarded a congressional medal at a ceremony in Washington, DC, attended by Mr Bush.

The last word?

EPA

Al Gore said (again) that he is not planning to run for the American presidency (again). The former Democratic vice-president was speaking after he won the Nobel peace prize in conjunction with the United Nations Intergovernmental Panel on Climate Change for informing the world about climate change. See article

Rudy Giuliani's presidential campaign was endorsed by Rick Perry, the governor of Texas. The backing, from such a prominent conservative, should help Mr Giuliani, who is pro-choice, in his effort to win over the Republican rank-and-file during the primaries.

Iowa's Republicans set January 3rd as the date for their party caucus, earlier than had been expected. The Democrats are considering the same date to hold their vote. See article

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Business this week

Oct 18th 2007
From The Economist print edition

Hank Paulson, America's treasury secretary, gave his strongest warning yet that the slowdown in the **housing market** and concurrent crisis in the credit and mortgage markets posed a “significant” risk to America's economy. Mr Paulson pointed out that the problems did not stem only from the subprime-mortgage market, and that the number of homeowners finding it difficult to make their mortgage payments in the “prime” market was on the rise.

Mr Paulson spoke soon after the Treasury prompted Citigroup, Bank of America and JPMorgan Chase to set up a fund that will buy highly rated assets from **structured investment vehicles**, which own mortgage-backed securities and have had trouble raising cash during the credit squeeze. Worth up to $100 billion (but involving no government money), the fund is designed to boost liquidity and confidence in the money markets. See article

Rocky foundations

Underlining the woes besetting America's homebuilders, **DR Horton**, the biggest by sales, said almost half its orders had been cancelled in the three months to September 30th. Meanwhile, figures showed that the **construction** of new homes in September was the lowest, at an annual rate, for 14 years.

Big banks continued to report mixed quarterly earnings. Whereas **Citigroup's** net income fell by 57%, compared with a year earlier, **JPMorgan Chase's** net profit rose slightly thanks to revenue from private-equity deals, which offset $1.6 billion in write-downs on leveraged loans and collateralised-debt obligations.

Northern Rock's share price took another battering amid anxiety about the benefit to shareholders of a potential takeover. The British bank was bailed out last month when it could not raise cash in the credit markets. Several parties are pondering a bid, including a consortium led by Sir Richard Branson's Virgin Group that includes AIG, America's biggest insurer. See article

India's stockmarket briefly tumbled after regulators proposed restricting capital inflows from derivatives sold offshore, which would affect a sizeable chunk of foreign portfolio investment. The government blames a surge of cash from abroad for driving up the rupee. See article

A graceful exit

Mike Turner said he would retire as chief executive of **BAE Systems** next August, much sooner than had been expected. Rumours that Mr Turner was pushed by the board of Europe's biggest defence company were denied. BAE gets around half its business in the United States, where its dealings with Saudi Arabia are being scrutinised by the Justice Department. See article

After a delay of two years caused by assembly problems, **Airbus** finally delivered its first A380 super-jumbo, to **Singapore Airlines**. The jet was handed over at a ceremony in Toulouse, where Airbus is based. Its first commercial flight, between Singapore and Sydney, is due to take place at the end of this month.

Boeing replaced the head of its 787 Dreamliner project. The company recently admitted that the first deliveries of the new jet will be postponed because of production snags.

Oracle made a $6.7 billion offer for **BEA Systems**, a rival business-software company, which was promptly rejected by BEA's board as too low. Carl Icahn, a veteran activist investor with a stake in BEA, has been pushing for a sale. See article

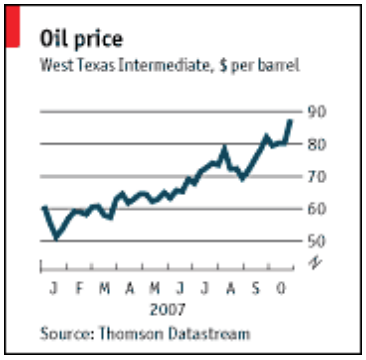
It was a busy week for Mr Icahn. **Biogen**, a biotechnology company based in Cambridge, Massachusetts,

announced that it was seeking a buyer and had received expressions of interest from several parties about a possible sale. Included is a proposal, rumoured to be worth $23 billion, from Mr Icahn.

Ericsson's share price plunged by 24% after the company issued a profit warning for the third quarter. The Swedish telecoms-equipment maker has seen sales fall because of a drop in demand for network upgrades in North America and Europe.

Following the joint venture between SABMiller and Molson Coors, there was further talk of consolidation in the beer industry after **Carlsberg** and **Heineken** said they were considering a joint bid for **Scottish & Newcastle**, Britain's biggest brewer.

Led Zeppelin agreed to make its lucrative back catalogue of songs available at **online music** stores. The legendary band had been one of only a handful of big acts still resisting digital sales of their work.



Gushing

Oil prices rose to record highs amid the prospect of a Turkish incursion into northern Iraq. Economists debated whether and when the seemingly ever-higher price of oil would damage the world economy. See article

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KAL's cartoon

Oct 18th 2007
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Illustration by Kevin Kallaugher

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The world economy

Lessons from the credit crunch

Oct 18th 2007
From The Economist print edition

Central banks have worked miracles for 30 years. Don't count on that continuing

AFTER a sudden market panic, all is well. Prices dropped precipitately, but investors have come to see that the Federal Reserve, under its new chairman, will not let the economy slide. Normality has been restored.

That was 20 years ago. Black Monday, October 19th 1987, was the day stockmarkets plunged; and Alan Greenspan, who won his central-banking spurs in that crisis, was the Fed chairman (see article). Two decades on, in the wake of this summer's subprime squeeze, stockmarkets are showing similar faith in Ben Bernanke, Mr Greenspan's successor. Despite bad news from the housing market and warnings from the treasury secretary, America's equity markets are still higher than they were in May. Amazingly, investors have been buying both on good news (don't worry, the economy is fine) and on bad (don't worry, the Fed will come to the rescue by cutting rates).

But the parallel with Black Monday does not work as well as investors might hope, for two reasons. First, this financial crisis is centred on the debt markets, not equities. Debt is more dangerous and in its current securitised form much harder to isolate. Interestingly, the money markets seem more worried about how the credit crunch may end than equity investors are. Interbank rates, though they have eased, are still high: not knowing which institutions might be on the hook for subprime losses and spooked by their own exposures, banks remain wary of lending to one another. And the repricing of mortgage-backed securities looks likely to be a protracted business. The news that big American banks, prodded by the Treasury, plan to set up a “super-conduit” in which to park instruments once valued at dozens of billions of dollars is a sign of how gummed up that market still is.

The more important flaw in the parallel concerns the role of central banks. The Fed emerged from the crisis 20 years ago with its reputation not just unscathed but also enhanced. This time round, the central banks' faults are painfully visible.

Dodgy dentists

Since the 1970s, the central banks' record has been remarkable. A generation ago, inflation around the world was high and variable. Now, by and large, it is low and stable. That has helped to foster steady growth. Central banks have done more than enough to justify the argument that monetary policy should be run by technicians rather than by elected politicians—an astonishing achievement in a democratic age. And “technicians” is the right word: central banking has become an increasingly technical business, performed by leading monetary economists equipped with ever more sophisticated theories and

statistical techniques. Granted, there is still a lot of art amid all the science, but if any economists have become the “dentists” that John Maynard Keynes thought they should aspire to be, it is those in central banks.

Nevertheless, as our special report in this issue argues, the past couple of months have demonstrated the limitations of central bankers and financial supervisors (they are not always under the same roof). This is so in at least three respects: monetary policy, economic modelling and bank supervision.

Loose monetary policy is partly responsible for the mess the central bankers are now trying to clear up. Other factors contributed to the crunch, including rash lending, securitisation and globalisation: when American subprime loans went bad, banks in Leipzig (which had bought the stuff) and in Newcastle upon Tyne (which hadn't—see article) were caught out. But whichever way you look at it, central banks kept interest rates too low for too long. That is most true of the Fed, which slashed rates between 2001 and 2003, held them at 1% for a year and then raised them in slow, predictable quarter-point steps, fuelling the housing boom. The results of that are plain to subprime borrowers facing the loss of their homes and to investors who ended up with subprime debt.

The other two limitations are both related to central banks' and supervisors' ability to control a much-changed financial system. One has to do with asset-price bubbles. The macroeconomic models used by many central banks focus on short-term influences on inflation; they focus less on the supply of money and credit. Even when they do have the right tools, central banks have preferred to wait till bubbles have burst, before mopping up afterwards by cutting rates. The snag is that this can start off new bubbles (as it did after the dotcom bust).

Credit where it is due

The last restriction has to do with supervision. Central bankers certainly gave warning that financial risks were being underpriced; contrary to some of their critics, they also had an eye on the off-balance-sheet entities in which banks parked their subprime assets. But they did not appreciate what the impact on the banks would be if those risky assets suddenly lost value. Like most of the people they regulated, the central bankers did not factor in the full effects of a liquidity squeeze.

In one way addressing these shortcomings is simply a matter of learning from experience. If monetary policy was too loose, very well: central bankers will have the chance not to repeat their mistakes. Fortunately inflation, as conventionally measured, has not taken off: that inflation expectations have remained low is a sign that markets and the public still believe central banks can keep prices stable. That may become more difficult, if, say, China is truly turning into a source of inflationary rather than disinflationary pressure. But it can be done.

Central banks should also think harder about what can be done to head off asset-price and credit booms before they turn into damaging and dislocating busts. One answer would be to consider extending the definition of inflation they already aim at to include property and shares. Alternatively—and perhaps more feasibly—they should be more willing to raise interest rates when credit growth is strong or asset prices are booming, even if consumer-price inflation is under control.

Supervision is harder—not least because over-regulation is a danger. Despite the howls from politicians, securitisation has been a boon for the world economy. That said, central banks and supervisors surely need more information not only about what banks have on their books, but also about what they may have to stump up for if liquidity dries up. One focus should be accounting: remarkably, pricing some instruments is so complicated that banks on both sides of an intricate trade have reported profits. The new Basel 2 banking regulations will force banks to recognise liabilities that until now they have been able to hide. But the Basel rules set too much store on the setting aside of capital; at times like these, what banks need is liquidity (which Basel puts less stress on).

No doubt central bankers will work at these shortcomings. But consider a paradox: the credit crunch has been caused by their successes as much as their failures. Low, stable inflation and strong, steady growth created an incentive for investors to go hunting for risk. The returns were tempting and with wise central bankers in charge, who could lose? Too many investors and bankers have outsourced risk measurement to the likes of Mr Greenspan and Mr Bernanke. Given the complexity of their job, that was truly irrational exuberance. If there is one lesson everybody should take away from the credit crunch it is that central bankers, no less than dentists, are only human.

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Turkey and Armenia

A resolution too far

Oct 18th 2007
From The Economist print edition

A congressional vote in Washington that could jeopardise Turkey's path westwards

Get article background

THE Turks are a proud, prickly people, easily offended by criticism. That much is clear from the row over a resolution, passed by a committee of the United States House of Representatives on October 10th, calling the slaughter of Armenians by Ottoman Turks in 1915 genocide. The full House has yet to vote on the resolution. But Turkey has reacted angrily, recalling its ambassador. It is talking of cutting military ties and even denying the Americans use of the Incirlik airbase that is vital for the supply of their troops in Iraq (see article).

As such threats demonstrate, Turkey is not just an angry ally. It is also a vital one, with a population of 75m and the world's 19th-biggest economy. It is a strategically important hinge between Europe and Asia; it has the biggest army in NATO after America's; it forms a crucial energy corridor to the West; and it borders on such awkward places as Iran and Syria as well as Iraq. Moreover, it is a rare example in the Muslim world of a lively, secular democracy. Yet internal tensions are exacerbated when clumsy outsiders intervene.

This year has seen a series of clashes between the army and secularists on one side and the mildly Islamist Justice and Development (AK) government led by Recep Tayyip Erdogan on the other, culminating in a big AK win in the election in July. Mr Erdogan is trying manfully to keep Turkey on the path towards membership of the European Union, even though many Europeans have become openly hostile. He also wants to preserve good relations with America despite renewed fighting with guerrillas of the Kurdistan Workers' Party (PKK), some based in the Kurdish region of northern Iraq. This is a bad moment for America to pick a fight over something that happened 90 years ago, before modern Turkey even existed.

That is not to deny it is a good idea for countries to face up to their past, especially when it was as violent as that of the Ottomans in the early 20th century. Germany has been admirably open about admitting the sins of the Nazi period; Japan has been less candid. It would be good for modern, democratic Turkey to come to terms with the terrible treatment of Armenians in the first world war (as also, in later times, of other minorities, including Greeks, Alevis and Kurds). In recent years, there have been encouraging signs: a few historians' conferences, an attempt to improve relations with Armenia, growing acceptance of the Kurdish language and occasional talk of amending Article 301 of the penal code. This makes “insulting Turkishness” a criminal offence and is used to shut down discussion of the Armenian genocide.

But the adoption of a highly political resolution in America's Congress is the worst possible way to encourage more steps in the right direction. Rather, it would serve only to fan the flames of Turkish nationalism and leave liberals within Turkey who want more open debate about the past even more exposed. Those in Congress who are pushing this resolution have little interest in Turkey or even Armenia, but a lot in the wealthy Armenian-American constituents who are lobbying them. It is telling that many Turkish Armenians, and even the Patriarch of the Armenian church of Istanbul, have not welcomed the House resolution.

One blunder after another

Recognising the damaging repercussions in Turkey as well as for Turkish-American relations, the Bush administration has been fighting to stop the resolution's passage. It has mustered all eight living former

secretaries of state, both Democrat and Republican, to argue against it. This is testimony to the strategic importance of Turkey. But it also reflects the especially sensitive time. This week the Turkish parliament gave its approval for a possible cross-border military incursion into northern Iraq to root out PKK terrorists based there.

That would be another blunder. The Turks' frustration over northern Iraq is understandable. In the past two weeks alone, some 20 Turkish soldiers have been killed by the PKK. Repeated requests to the Iraqis and local Kurdish authorities to clamp down on the group have been ignored. Yet an invasion would not only upset the most stable region of Iraq but also be unlikely to work, as even some Turkish generals recognise. It would be better for the Americans to do more to counter the PKK in northern Iraq—and for Turkey to renew its earlier efforts to improve the lot of Kurds in its south-east.

Keeping Turkey on its pro-Western course is vital, not just for Iraq, but for the sake of all Turks, including the country's own big Kurdish population. Recent rows have helped to turn Turkish public opinion sharply against both the European Union and the United States, a situation that countries such as Iran and Russia are all too ready to exploit. Pressure to scrap Article 301 and allow open debate in Turkey should continue. But the House resolution is not the way to do it.

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The Republicans and business

Fractured alliance

Oct 18th 2007
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American conservatives need to rediscover the charm of small government

Reuters

ONE thing the Republican Party has usually been able to depend on is the support of well-off capitalists: from Calvin Coolidge's declaration that “the chief business of the American people is business” to George Bush's generous tax cuts, it has always been pretty clear to wealth-creators which side their bread is buttered on. No longer. With all polls predicting a Democratic sweep of House, Senate and presidency in 2008, the smart money is flowing the Democrats' way.

A *Wall Street Journal* poll last month showed that only 37% of professionals and managers identify themselves as Republicans or leaning that way. A YouGov/Polimetrix poll for *The Economist* finds that only 44% of those earning more than $150,000 plan to vote Republican. So it is no surprise—though historically astonishing—that the Democrats' presidential candidates have raised substantially more than Republican ones.

There are several obvious reasons for this. The shrill voices of religious conservatives have driven away many pragmatic Republicans who feel that banning abortion and gay marriage are not the most pressing issues confronting America. The Bush administration's incompetence, evident from Iraq to Louisiana, alienates people who know about management.

But the most damaging factor has been the Republicans' inability to control the federal budget. By slashing taxes without cutting spending, Mr Bush turned the budget surplus of $240 billion he inherited from Bill Clinton into a deficit that bottomed out at over $400 billion, and is still running at $160 billion. Mr Clinton's free-trade record was better as well. The current crop of Democrats are less angelic: they are a protectionist bunch and they show few signs of wanting to curb big entitlement programmes. But, for the moment at least, they look better than the Republicans on spending. For instance, they have instituted “pay-go” rules, which mean that any new spending must be fully funded; and they have stuck to them.

Belatedly (to put it mildly), the administration has realised that it has lost the mantle of sound economic management to the Democrats. On October 3rd Mr Bush picked up his dusty veto pen, using it to cut back spending for the first time in his presidency. Astonishingly, he chose the wrong issue to wield it on: a proposal to expand a highly popular scheme that subsidised health insurance for poorer children. This from a man who had let Republican pork through by the sty-load.

Try Main Street, not Church Street

In truth, given his record, Mr Bush's chances of looking a convincing small-government conservative are

close to zero. The presidential candidates are different. Both Rudy Giuliani, the current front-runner, and John McCain have proposed promising market-oriented proposals on health care (see article). They also talk much more favourably than Democrats do about free trade and fiscal control. What is needed from them—and Mitt Romney as well—is more detail.

Taxes, trade, health care: these are subjects Main Street wants to know more about. But the religious right does not. Rather than building a pragmatic centre-right alternative to Hillary Clinton, the conservative movement is stuck with God, gays and guns. The immensely powerful “family” movement is gathering this weekend in Washington—and all Republican candidates are dutifully attending. As long as the business of the Republican Party seems not to be business, it can hardly complain if businesspeople look elsewhere.

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Sudan

That other war

Oct 18th 2007
From The Economist print edition

Relentless pressure got the UN into Darfur. More is needed to save the south

Get article background

NOT surprisingly, Darfur has grabbed the world's attention where Sudan is concerned. The horrors of the past three years, with at least 200,000 Darfuris dead, are unspeakable. But in the longer run another part of Africa's largest country has suffered even more death and misery: Sudan's southern region. Unless strong diplomacy is fast brought to bear there, an even bloodier cycle of despair and destruction could start all over again—and make it much harder to make a lasting peace everywhere in the country, including in Darfur.

Mercifully, an edgy peace has prevailed in the south since 2005, when a “comprehensive peace agreement”, known as the CPA, ended a war between Sudan's Muslim and mainly Arab north and its black Christian and animist south that had stretched back, with the occasional truce, to independence from Britain half a century ago—at a cost of some 2m lives. But that agreement is now hanging by a thread. A complete breakdown could make the debacle in Darfur, in Sudan's west, look modest by comparison. Saving the southern peace accord must be the priority, even while the UN and the African Union prepare for a Darfur peace conference in Libya this month.

A week ago the southern peace arrangement ceased to function when the Sudan People's Liberation Movement (SPLM), which led the southerners in their long war against the northern-dominated Sudanese army, walked out of Sudan's government of national unity in Khartoum, the capital (see article). The peace agreement stipulates that the SPLM and the ruling Islamist National Congress Party, led by the country's president, Omar al-Bashir, must implement the terms of the accord together. It provides for the revenue from south Sudan's abundant oil to be shared equally between north and south, and for a referendum to be held in 2011 whereby the south, if its people so wish, can secede and become a fully independent country. Under the deal, the north promised to remove its troops from the south and to accept independent arbitration to mark the boundary between north and south.

Bashir unabashed

The southerners say, with justice, that Mr Bashir has been trying to wriggle out of the obligations laid down in the accord, just as he has spent years breaking promises to end the conflict in Darfur. In particular, he has refused to abide by a “final and binding” ruling of an independent commission on a new boundary for Abyei state, which straddles the north-south division and holds a vast dollop of Sudan's oil.

The only way to save the north-south agreement is to apply the same relentless pressure on the government in Khartoum that obliged it to sign the deal in the first place and which has now forced Mr Bashir to accept a UN force that is expected to arrive soon in Darfur. The Americans have pushed hardest but, preoccupied by Darfur and crises farther afield, they have relaxed their guard in Sudan's south. They must urgently rally the many governments, Western and African, that have wet-nursed Sudan's north-south agreement and persuade Mr Bashir to meet his obligations over the boundary and the troop withdrawals. They should threaten to apply the same sanctions against Sudan over the south as over Darfur.

Nobody matters more than China. The biggest consumer of Sudan's oil has belatedly started to play its part over Darfur. It is in China's interest to have a stable Sudan. In the short run, some in Beijing may gamble it would be best for their friend Mr Bashir to keep as much of Abyei and its oil as he can. That would be a huge mistake: it would risk a return to a much bigger war than the one in Darfur—and would

shut down much of Sudan's oil production, not just in Abyei. If China wants to guarantee its long-term investment, it needs to put pressure on Mr Bashir to do the right thing in all parts of his country.

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Japan

Don't furl the flag

Oct 18th 2007
From The Economist print edition

Japan's soldiers deserve better support from its politicians

Reuters

FOR the first time since it started sending its soldiers, sailors and airmen to report for duty in the world's trouble-spots, Japan is about to sound an embarrassing retreat. In November supply vessels and escort ships, deployed to the Indian Ocean for the past six years in support of counter-terrorism operations in Afghanistan, will steam home to a political crisis over their role that will confine them to port for months. Worse, it could end Japan's role in Operation Enduring Freedom, the crucial battle against the Taliban.

So is this the Japan of old: self-absorbed, unashamed at leaving others to do the hard military tasks? The row about the ships has triggered a crisis of confidence about what Japan's role in the world should be (see article). But with luck the debate will also remind Japan's voters, its neighbours and its allies of what all stand to lose should Japan go AWOL.

Cocooned in its protective alliance with America, Japan started scrambling to attention when it discovered that its cheque-book diplomacy in the 1991 Iraq war bought neither influence nor gratitude. Since then, North Korea's threatening missile tests and rival China's increasingly capable ships, submarines and aircraft (and its missile build-up near Taiwan) have drawn Japan into more active service with America.

For the past 15 years Japan has also volunteered for a variety of peacekeeping duties for the UN. But after the September 11th attacks, its Self-Defence Forces (SDF is a euphemism for its armed forces that gets round its pacifist-sounding constitution) have been deployed in much more determined fashion. Besides those supply vessels loitering in the Indian Ocean, Japan has contributed soldiers for reconstruction work and air crews for logistics support in Iraq. Its ships and aircraft have assisted relief efforts from post-tsunami Indonesia to quake-stricken Pakistan. Lately it has struck up closer military ties with Australia and to a lesser degree India, and drawn closer to NATO and the European Union.

For Japan's government, this broader military effort has had a clear diplomatic purpose. Japan would like a more permanent seat on the UN Security Council and presents its readiness to shoulder some of the harder security tasks as one of its credentials. A more striking global role, its military component firmly anchored in co-operation with allies and with the UN, is also a way of bolstering Japan's influence against a rising China and a confident Russia without causing alarm.

Most Japanese have been comfortable so far with the good work their soldiers have been doing. That is partly because, in carrying the flag to dangerous places, the SDF, relying on the protection of others, has taken no casualties (though Japan has lost some courageous diplomats). But such support is another reason to hope that Japan's well-drilled and helpful defence forces are not about to be ordered back to barracks.

Support your troops

It is a pity then that the ships row—which started as a cynical ploy by Japan's opposition Democratic Party (itself in favour of a bigger security role for Japan) to bring down the government—is preventing the Diet debating more useful things. The cap was officially lifted 20 years ago, but Japan's defence budget is still under 1% of GDP and so is increasingly stretched by the SDF's new overseas duties. Draft legislation to lay down more predictable guidelines for deploying troops overseas will languish until the row about the ships is resolved. It would help too if tight limits on the numbers of SDF members able to be deployed at any one time and for how long could be eased. Japan's soldiers do increasingly difficult jobs around the world. They deserve better support at home.

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On business and caste in India, the Israel lobby, Hillary Clinton, space, Arthur Conan Doyle

Oct 18th 2007
From The Economist print edition

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India's labour divisions

SIR – Your briefing on business and caste in India claims there is "no strong evidence" that companies discriminate against *dalits* and other members of the lower castes ("With reservations", October 6th). Our two-year study, which we will soon present, found widespread discrimination against highly qualified low-caste individuals. We sent out 4,800 applications in response to advertisements for graduate jobs in Indian and multinational companies. These applicants bore distinctively upper-caste names, Muslim names and *dalit* surnames, but were otherwise identical in educational qualifications and work experience.

The odds of a *dalit* being invited for an interview were about two-thirds of the odds of a high-caste applicant with the same qualifications. The odds of a Muslim applicant being invited to an interview were even worse: only one-third as often as the high-caste Hindu counterpart.

The evidence is solid. Serious policies, coupled with an overhaul of India's education system, are required to overcome this pernicious form of social exclusion. Maybe then the widespread relegation to the bottom of the barrel of India's poorest castes will begin to diminish.

Paul Attewell
Professor of sociology
City University of New York
New York
Katherine Newman
Professor of sociology
Princeton University
Princeton, New Jersey

SIR – To support your contention that Hinduism blesses the caste system you quote an ancient text, the Laws of Manu ("Untouchable and unthinkable", October 6th). Yet most Hindus will not have read it. The Hindu faith is very old and has many voices, opinions and scriptures, some of which can present a distorted view of the religion. The most authoritative scripture that describes Hinduism most completely is the Bhagavad-Gita, which does not support or promote the caste system.

Abhinandan Singh
Mumbai

Power in context

SIR – Your review of our book, "The Israel Lobby and US Foreign Policy", focuses on our discussion of the Iraq war ("Powerful, but not that powerful", September 29th). We do not see Israel and the Israel lobby as the sole cause of that conflict. Most wars have complex causes, and Iraq is no exception. The idea of using force to topple Saddam Hussein originates from a small group of neoconservatives, most of whom are strongly pro-Israel. They believed victory would be easy and benefit America and Israel alike. Organisations in the Israel lobby either endorsed the invasion or helped persuade Congress to convince it to authorise the use of force.

In short, the Israel lobby was a necessary but not sufficient condition for the war. Had the neoconservatives not been pushing for war from 1998 onward, it would almost certainly not have

happened. But had Al Gore become president, or had September 11th never occurred, the United States probably would not be in Iraq today.

John Mearsheimer
Professor of political science
University of Chicago
Chicago
Stephen Walt
Professor of international affairs
Harvard University
Cambridge, Massachusetts

The front-runner

SIR – I note that you describe Hillary Clinton as "an exemplary senator" without mentioning anything she has accomplished ("Ready to run the movie again?", October 6th). You do observe that she is a regular attendee at Senate prayer breakfasts, but few genuinely distinguished senators would place this high on their list of achievements. The salient feature of American public life today is the extent to which the business of the permanent campaign has come to dominate the business of government. The media has been all too willing to accept a zeal for and commitment to the former as evidence of competence at the latter.

Joseph Britt
Sun Prairie, Wisconsin

SIR – The biggest surprise for Americans if Hillary becomes president will be her solid, unspectacular competence at governing and getting things done. Voters in New York have witnessed her ability to move the wheels down there in Washington. Based on that record, one expects she will be a rather startling change from the current administration with its angry, childish view of the world, and its demonstrated inability to do much more than start fights and leave them for others to finish.

Christopher Rowley
Ellenville, New York

SIR – I am sceptical about the ability of Senator Clinton to enter the international arena as a "healer" ("The comeback kids", October 6th). When applied to domestic politics, the concept is laughable. Mrs Clinton's every instinct is to push hard for the dictatorial agendas of the main interest groups backing the Democratic Party, particularly the labour unions and the greens. We need a "do-nothing" president who might throttle back the frequent excesses of executive-branch agencies, but pursue no grand schemes for remaking society. I see Hillary as the precise opposite of that.

George Leef
Raleigh, North Carolina

SIR – Mrs Clinton is not "married to a former president who was impeached for having oral sex with an intern in the Oval Office". She is married to a former president who was impeached for perjury and obstruction of justice. Democrats often forget this.

Actually, there are no laws against a president having oral sex with an intern in the Oval Office, or Bill Clinton would have been impeached for that offence, too. Republicans often regret this.

Bonnie Wren
Carlsbad, California

Star trek

SIR – You emphasised the "macho, gung-ho" nature of the space race ("Spacemen are from Mars", September 29th). Yet in a recent film documentary, "In the Shadow of the Moon", Michael Collins recounts how in every place the returned *Apollo 11* astronauts went they received the same friendly welcome. Instead of saying "Well, you Americans did it," people said, "We did it. We, humankind, we the human race, we, people, did it."

It is a shame that that feeling, as fleetingly aberrant as a walk on the moon, quickly evaporated. Today, in an age when GPS, Google Earth, i-this and my-that pander to our increasingly solipsistic need to be at the centre of the universe, it is perhaps time to start looking up again, instead of continually looking down.

Ian Whittingham
Darien, Connecticut

It's elementary

SIR – It is unlikely that Arthur Conan Doyle was “one of the best-known Englishmen in the world”, as he was a Scot (“A man divided”, October 6th). Anyone who views the extant film interviews with him at Surgeons' Hall Museums in Edinburgh will be left in no doubt. Surgeons' Hall also houses a fascinating exhibition on Dr Joseph Bell, Doyle's inspiration for Sherlock Holmes.

Kenny Bell
Asunción, Paraguay

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Turkey and America

Unearthing the past, endangering the future

Oct 18th 2007 | ANKARA, WASHINGTON, DC, AND YEREVAN
From The Economist print edition

Camera Press

Turkey votes to invade northern Iraq; Congress considers the Armenian genocide. The two are dangerously connected

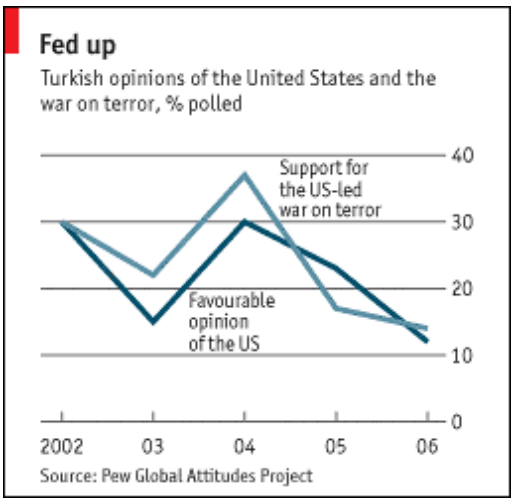
Get article background

STANDING before a blurred photograph of a ditch full of emaciated corpses, an elderly woman begins to cry. “The Turks are butchers,” hisses another. These women are among thousands of diaspora Armenians who travel from all corners of the globe to pay tribute to their dead at the genocide memorial in Yerevan. “Our objective is not to attack this or that country,” explains a grim-faced guide. “It is to ensure recognition of the first genocide of the 20th century, that of 1.5m Armenians by the Turks.”

For decades, Armenians round the world have lobbied for explicit official recognition of their point of view. Over the years, Armenian groups in America (where perhaps 400,000 people have Armenian ancestry) have persuaded 40 out of 50 states to recognise the genocide. They seemed poised to snatch their biggest trophy yet when the Foreign Affairs Committee of America's Democrat-controlled House of Representatives passed a bill on October 10th stating that “the Armenian genocide was conceived and carried out by the Ottoman empire from 1915 to 1923.” But this was overshadowed, on October 17th, by another, related, vote: the Turkish parliament's decision to allow the government to clobber guerrillas of the homegrown Kurdistan Workers' Party (PKK) in their haven in northern Iraq.

For, even as Congress has been considering a war that is almost a century old, America's present war in Iraq has made Turkey newly vulnerable to Kurdish attacks. The de facto autonomy enjoyed by Iraqi Kurds has encouraged the PKK. Many PKK guerrillas are now attacking the Turks from bases in Iraq. As many as 20 Turkish soldiers have died in clashes with the PKK in the past two weeks alone. The Turks have held back from retaliation, largely because they hoped that America would deal with the PKK itself. Its failure to do so, mainly because it fears upsetting its Iraqi Kurdish allies, is the biggest cause of rampant anti-American feeling in Turkey, which has been strengthening for some time (see chart). So although President George Bush warned Turkey, just before its parliamentary vote, that it was not in its interests to send troops into Iraq, the Turks ignored him. “The genocide resolution poured more oil on to the flames at the worst possible time,” observes Taha Ozhan of the SETA think-tank in Ankara.

Echoes of the Ottomans



The raw facts of the Armenian tragedy are not disputed. In 1915 many hundreds of thousands of Armenian civilians were deported to the deserts of Syria and Iraq. They were more than likely to die on the journey from starvation, exhaustion and attacks by robbers or irregular fighters. Their deportation, in the view of most Western historians, fits the United Nations' 1948 definition of genocide: an action intended “to destroy in whole, or in part, a national, ethnic, racial or religious group”. That conclusion is based in part on the testimony of Christian missionaries and Western diplomats, who observed at close hand the atrocities inflicted on the Armenians and concluded that this was not just brutal deportation, but a policy of extermination.

Turkey admits that several hundred thousand Armenians did die, but says this was not because of any centrally organised campaign to wipe them out. The deaths, it says, were a result of the chaos convulsing the Ottoman empire in its final days—a collapse accelerated by the treachery of its Armenian subjects, who had sided with invading Russian and French forces. In short, the tragedy was war, not genocide. This is the version taught to Turkish schoolchildren, who are also told that many more Turks were killed by Armenians than vice versa. Turks remember, too, that in the 1970s some 47 of their countrymen, many of them diplomats, were killed by Armenian militants.

Genocide is a tricky subject in Washington. Six weeks after the Rwandan genocide began in 1994, when 500,000 people had already been murdered for belonging to the wrong tribe, the American government still hesitated to call it what it was. The trouble with calling genocide “genocide” while the blood is still spilling is that, under the terms of a UN convention, one is obliged to do something to stop it.

The Armenian killings incur no such awkwardness. Obviously, Congress cannot do much about a massacre that happened nearly a century ago. But that does not mean that its words carry no cost. Being branded as the precursors of Hitler “is a very injurious move to the psyche of the Turkish people,” said Turkey's ambassador to Washington, before he was withdrawn for “consultations”. And plenty of Americans who dismiss the Turkish account as whitewash nonetheless think that their lawmakers are fools for saying so aloud.

Turkey is a key ally in a region where America has too few. Three-quarters of the air cargo heading into Iraq passes through Incirlik air base there. American planes fly freely through Turkish air space en route to Iraq and Afghanistan, and the American navy uses Turkish ports. Turkey provides Iraq with electricity and allows trucks laden with fuel to cross its border into Iraq. But if American politicians persist in dishing out what Turks perceive as a grave insult, it will make it harder for the Turkish government to continue co-operating so closely with America.

That is why Mr Bush urged Congress to ditch the bill. Eight former secretaries of state, from both parties, urged the same. The current secretary of state, Condoleezza Rice, called Turkey's foreign minister, prime minister and president to mollify them. She also dispatched two able lieutenants to Turkey. She tried to reassure Ankara that “the American people don't feel that the current Turkish government is the Ottoman empire”. Jane Harman, a Democrat who had originally co-sponsored the House resolution, has now withdrawn her support, noting that the House had already passed similar resolutions in 1975 and 1984, and that doing so again would “isolate and embarrass a courageous and moderate Islamic government in perhaps the most volatile region in the world.” Without, she might have added, saving a single Armenian.

Foreign-policy experts, too, are aghast. Steven Cook of the Council on Foreign Relations, a think-tank, laments the cavalier way Nancy Pelosi, the speaker of the House, and her Democratic cohorts are treating relations with a crucial ally. Anthony Cordesman of the Centre for Strategic and International Studies frets that the bill will create “yet another pointless source of anger” against America in the Middle East. The White House has promised to do all it can to prevent the full House from voting on the resolution—though Ms Pelosi, whose Californian constituents include many rich Armenians, has promised that the measure will reach the House floor by mid-November.

Meanwhile, the Turkish government has racked up its lobbying in Washington by several degrees. If the resolution passes the full House, it has hinted, use of the Incirlik base may be denied. “Unfortunately, some politicians in the United States have made an attempt to sacrifice big issues for minor political games,” said Turkey's newly elected president, Abdullah Gul. The hawkish army chief, General Yasar Buyukanit, gave warning that if the House bill went through, “our military relations with the US will never be the same again.”

By October 17th, both Republican and Democratic congressmen were beginning to back away from the resolution. Around a dozen of them withdrew their support, and its chances of passage looked much dimmer than before. “This vote”, said the head of the Democratic caucus, “came face to face with the reality on the ground.” But the damage, it could be argued, had already been done.

The Kurdish provocation

Turkey is now seething with conspiracy theories about American and assorted Western ne'er-do-wells wanting to weaken and divide the country, as they did when the empire collapsed. Kurds and Armenians are connected in villainy. At the recent funeral of a Turkish soldier killed by the PKK, a state-appointed imam declared to mourners that “the Armenian bastards” were “responsible” for his death.

All this has intensified the pressure on the mildly Islamist prime minister, Recep Tayyip Erdogan, to wade into northern Iraq soon. Threats of a Turkish invasion have helped to push world oil prices to new highs. Meanwhile the PKK, in a statement, said its fighters would defend the Kurds and their interests to “the last drop of blood”.

Yet despite the chest-thumping, Turkish officials privately concede that a large-scale cross-border operation is a rotten idea. Turkish soldiers run the risk of getting bogged down, much as the Israelis did in Lebanon. And as Mr Erdogan himself acknowledged last week, in a recent interview with the CNN news channel, “We staged 24 such operations in the past and can we say we achieved anything? Not really.” In reality, a Turkish incursion would probably win the PKK fresh recruits while driving an even bigger wedge between Turkey and America. It would also provide ammunition for countries, such as France and Austria, which argue that Turkey should be given “privileged partnership” of the European Union rather than full membership.

And there lies another source of sourness. Disillusionment with the EU is reflected in polls that show support for membership among Turks is slipping from a high of 74% in 2002 to under 50% this year. Waning EU influence may, in turn, leave Turkey feeling less constrained about plotting mischief inside Iraq.

“If Turkey goes in [to Iraq] it will become isolated, authoritarian, a very nasty place,” says Soli Ozel, a political scientist at Istanbul's Bilgi University. Like many fellow liberals, he blames the current mess as much on EU dithering as on Mr Erdogan and his ruling Justice and Development (AK) Party. Riding on a wave of sweeping reforms and economic recovery, the AK romped back to solo rule in the July elections with a bigger share of the vote.

AK should have used this mandate to tackle Turkey's most urgent problems. It might have begun with

Armenia, by considering America's plea to open its borders with it. These were sealed in 1993 after the tiny landlocked state, once part of the Soviet Union, invaded a chunk of ethnically Turkic Azerbaijan in a vicious conflict over the enclave of Nagorno-Karabakh.

Over the past few months the Americans have been working on a proposal calling for Turkey to establish formal ties with Armenia and to end its blockade. In return, Armenia would recognise its existing border with Turkey and publicly disavow any territorial claims, including the claim to Mount Ararat, its national symbol. A deal of that sort might have helped the Bush administration head off the genocide resolution, and could possibly have squashed it for good.

Drinking in Yerevan

A recent poll conducted by the International Republican Institute, a pro-democracy pressure group, suggests that the people of Armenia—unlike their brothers and sisters in the diaspora—may be ready for change. Only 3% of respondents said that recognition of the genocide was their first priority. A mere 4% listed it at all. For many, finding a job is their chief worry.

Meanwhile, Turkey has looked the other way as thousands of illegal Armenian migrants have sought work in Istanbul, the former Ottoman capital. Mutual suspicions are beginning to fade as these newcomers are recruited by Turks to care for babies and ageing parents. Armenian tourists, too, braving accusations of treachery back home, have been heading by the thousands to Turkey's Mediterranean resorts. “Until I met a real Turk, I rather feared them,” confesses Tevan Poghossian, an Armenian pundit, who runs projects to promote Turkish-Armenian dialogue. “Now I go out drinking with them in Yerevan.”

The few Turks who travel the other way can discover that they have more in common with their Armenian neighbours than they suppose. A visit to the open-air vegetable market in Yerevan reveals that many of the words for vegetables are the same (and so, too, are some of the swear-words). As often as not, Turks who identify themselves are greeted with a big smile and even with a discount. And a simple apology for the events of 1915, without mention of the G-word, can melt the ice.

In a gesture of goodwill, Turkey this year restored a much-prized Armenian church in the eastern province of Van. Armenian officials were among those invited to attend its opening—albeit as a museum—in March. And a growing number of Turks, secure in the knowledge that Ataturk, the revered founder of modern Turkey, had no hand in the killings, are beginning to question the fate of the Ottoman Armenians. A few intrepid souls such as Taner Akcam, a historian, have even dared to call it a genocide.

Despite this burgeoning spirit of reconciliation, however, Turkey has balked at establishing formal ties and insists that Armenia must make the first move. Armenia retorts that it is up to Turkey to prove that its overtures are not designed solely to kill the genocide resolution; to prove its good faith, Turkey should act first. Mr Erdogan's lieutenants blame the impasse on Turkey's meddlesome generals, who insist that Armenia must make peace with Azerbaijan before it can make peace with Turkey.

It is also the army that is blocking political accommodation with the Kurds, they say. But since the AK was returned to power with 47% of the popular vote, such excuses are looking thin. If the government were sincere about democracy, it should have scrapped the notorious Article 301 of the penal code that makes it a crime to “insult Turkishness”. Hundreds of Turkish academics and writers, including Orhan Pamuk, a Nobel prize-winner, have been prosecuted under this article. One of its targets, Hrant Dink, an Armenian newspaper editor, was murdered in January by an ultra-nationalist teenager who accused him of insulting Turkey. His lawyers accuse the government of covering up the affair, despite evidence that at least one rogue security official was involved in plotting Mr Dink's death.

As long as Article 301 remains on the books, there is no substance in Mr Erdogan's call for historians, not politicians, to investigate history. As Mr Ozel points out, “Anyone who disagrees with the official line can end up behind bars.” Article 301 also makes it harder for Turkey's own Armenians to oppose recognition of the genocide by foreign governments, on the ground that it is better for Turks to arrive at the truth themselves. Instead, nationalist rage is stoked up on both sides.

Turning a deaf ear to such criticism, the government has wasted precious political capital on writing a new constitution. The current document, written by the generals after their last coup in 1980, undoubtedly needs to be replaced. Yet by insisting on provisions that would enable veiled women to attend university, the government has been accused of promoting a covert Islamist agenda.

It did not help when, overriding American objections, Turkey signed a gas-pipeline deal with Iran last July. Mr Erdogan's bent for flirting with rogue regimes in Iran and Syria, and for talking to Hamas in the Palestinian territories, may not have influenced the voting on the genocide resolution, but cannot have made congressmen warm to Turkey either.

To make matters worse, Turkey has given warning that its strong military ties with Israel may suffer if Israel fails to stop the resolution being passed. It is threatening to sever air links between Turkey and Yerevan and to expel Armenian migrant workers if the Armenian government does not lobby on its behalf. Turkey refuses to believe that neither Israel nor Armenia has the power to influence Congress, a fact which shows “just how little Turkey understands the way our country works”, moans a frustrated American official. “It also shows that Turkey lacks the stomach to take on the Americans, so it is going after an easier target, Armenia, instead.”

With luck, the resolution will be shelved and Turkey, its pride salved, will rethink its policies. With luck too, it will recognise that a full-blown invasion of northern Iraq would damage its interests and further inflame Kurdish separatists. If Turkey wants to fulfil its dreams of being a regional power and an inspiring example of how Islam and democracy can co-exist, it must make peace with all its citizens, including its Kurds. And it should find a way to face up to its past. It could do worse than seek inspiration from Ataturk who, as Mr Akcam noted in a recent book, once called the Armenian tragedy “a shameful act”.

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The Democrats in Iowa

Battle amid the corn

Oct 18th 2007 | DES MOINES AND GREENFIELD
From The Economist print edition

Getty Images

The Democrats are slugging it out with not much more than two months to go before the first presidential votes are cast

GREENFIELD, Iowa, is the sort of small, Midwestern town where the local coffee shop closes at two in the afternoon. But on October 16th the Brick Coffee House kept its doors open well past five to serve the small throng of reporters waiting for John Edwards to arrive. “You are the guardians of what kind of president we're going to have”, the former vice-presidential nominee told a motley crowd in Greenfield's meeting hall, including a corn farmer in railroad engineer overalls. “You're first. You are in a different place.” This is not idle pandering. Mr Edwards has staked his new candidacy on winning in Iowa in January, when the state's Democrats will pick candidates at local caucus meetings, and he is not the only one.

Ever since Jimmy Carter's 1976 victory in Iowa energised his campaign, winning the first state in the nominating cycle has obsessed presidential hopefuls. It was crucial for John Kerry in 2004, who defeated the front-runner, Howard Dean, there. This time around, Democrats John Edwards and Barack Obama and Republican Mitt Romney are betting big on the state. Iowa is “the whole shebang”, David Plouffe, Mr Obama's campaign manager, told the *New Republic* last month.

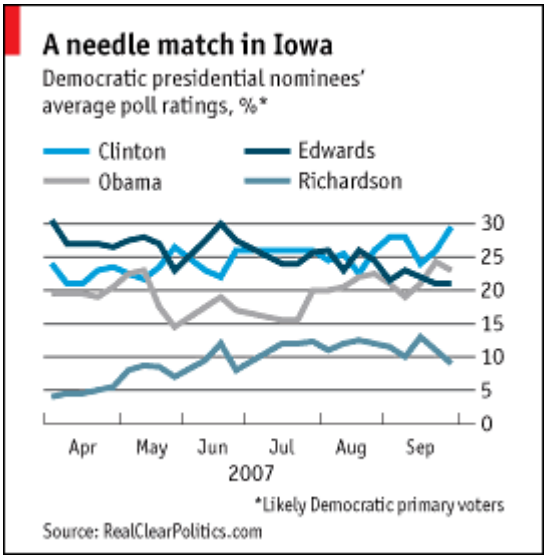
Two things must happen for the Iowa gambit to work in 2008. The parties' front-runners have to lose the state. Then those who do win there will have to translate that victory into new support in the other early primary states. On the Democratic side, where Hillary Clinton is running formidably out in front, the first is distinctly possible. But the second looks improbable, at least for now.

Unlike in other early states, the race in Iowa is still close. Mrs Clinton and Mr Edwards have traded the lead in polls for months, and over the summer Mr Obama made it a three-way race. The latest poll shows Mrs Clinton ahead but still vulnerable with the support of 33% of likely Democratic caucus-goers to Mr Edwards's 22% and Mr Obama's 21%. Other recent polls have been a lot closer.

The state's quirks can favour second- or third-place contenders. If too few supporters of a particular Democratic candidate show up at a particular caucus site for that candidate to be deemed “viable”, his or her voters get to make a second choice. Democrats committed to marginal campaigns may not be inclined to choose the establishment candidate.

Mrs Clinton also is far from the ideal candidate in Iowa. Her husband signed the North American Free-Trade Agreement, which many blame for economic turmoil in the region. On a recent swing through Newton, where a Maytag plant will close next week, Mr Obama promised to fight a trade pact with South

Korea.



Mrs Clinton's opponents have been campaigning heavily in Iowa for months: Mr Edwards has honed his populist pitch there since 2004, playing on his upbringing as the son of a small-town millworker. Mr Obama's rhetorical flair dazzles the crowds, and he has held almost as many events there as Mr Edwards this year—124 compared to 146, says the *Washington Post*. Mr Obama's insistence that he is a different kind of politician—one who listens to all sides—appeals to Bush-sick Democrats.

But some Iowans argue that the former first lady is actually performing remarkably well in the state, given the emphasis the other candidates have placed on winning it. After so much campaigning, Mr Edwards will find it hard to build additional support. Still, David Redlawsk, who runs the University of Iowa's polling outfit, says Mr Edwards appeals all over the state, and he might be the second-choice candidate of many Iowa Democrats on caucus night.

Mr Obama's numbers, meanwhile, rely on young Iowans. In a recent *Des Moines Register* poll, he badly trailed Mrs Clinton among the elderly who are historically more likely to attend a long caucus meeting than younger supporters. He is now becoming more feisty in the state, claiming that he is the candidate best able to bring about changes, such as universal health coverage, a reference to Mrs Clinton's failure to pass her health plan in 1993-94.

The dangers of insurgency

How significant a setback would losing Iowa be for Mrs Clinton? Mr Redlawsk argues that if she is not leading as she goes into the caucuses, a loss could be written off as something quirky and Iowan. If she is expected to win and doesn't, her supporters in other early states might lose heart.

Iowa's influence will also depend on when its caucuses happen. Iowa state law requires it to hold them eight days before other contests, and the speculation now is that state Democrats will caucus either on January 3rd or 5th (the Republicans this week plumped for the 3rd). That would leave more time for heads to cool before February 5th, this election cycle's Super Tuesday, when 22 states, including several big ones, will vote.

In any event an Iowa loss should not be fatal. Mrs Clinton holds double-digit leads in the other early states. Unlike Mr Dean's, her campaign is famously disciplined and does not rely on the support of young “netroots” activist types. Democrats are generally nostalgic for her husband's presidency. Many female Democrats would like to see a woman in the White House.

For now, the real danger for Mrs Clinton in Iowa is that the contest will pull her away from the centre. Satisfying a leftist base will not be a general-election winner in 2008. So far, she has resisted this temptation pretty well. But the Iowa race still has around ten weeks to run.

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Health care

The right question

Oct 18th 2007
From The Economist print edition

Welcome attention to the real problem

SENATOR JOHN McCAIN is famous for his straight talking, spelling out uncomfortable truths even when they do him political damage—whether on Iraq, torture, immigration or free trade. Now he has decided to deal with health care bluntly too: American health-care costs are much too high, he says, and the priority for any reform must be to bring them down.

Speaking on the campaign trail in Iowa on October 11th, Mr McCain put cost front and centre as he unveiled his own health plan. He noted that General Motors spends more on health than it does on steel: the price of each of its cars includes more than $1,500 for health care. Toyota's health-care costs come to about $200 a car.

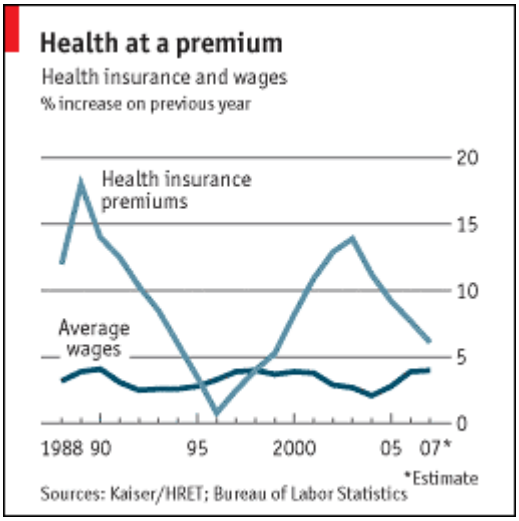
The other candidates all mention cost, of course. But for those on the Democratic side, the priority in this election is not cost but coverage. Some 47m Americans lack any form of health cover, being neither poor nor old enough to qualify for government-funded health schemes, and having neither a generous enough employer nor sufficient financial resources of their own to pay for private health insurance. This, on average, now costs some $12,000 a year for a family of four, according to the Kaiser Foundation, a Washington think-tank.

All the leading Democratic candidates have produced detailed plans for making coverage universal, involving subsidies for those who can't afford insurance and—at least in the case of Hillary Clinton's and John Edwards's plans—a legal requirement that everyone be covered. Even on the Republican side, plans produced by Rudy Giuliani and a few others focus more on using market mechanisms (not subsidies, as the Democrats prefer) to expand coverage than on overall costs.

But cost plainly is the biggest issue. For the past four decades, American health-care costs have usually increased faster than the economy has grown, by an average of an extra 2.5% a year. Health care now consumes around 16% of America's entire GDP, a much higher proportion than in other industrial economies.

Ever-rising costs of this kind are not sustainable. They damage the competitiveness of companies, one reason why the proportion of firms offering health care to their employees has been steadily falling, from 69% in 2000 to 60% now. And these figures do not capture the extent to which squeezed companies have been scaling back their health plans, obliging employees, for instance, to pay a higher share of treatment costs, or refusing to cover other members of employees' families.

For people who must pay for their own insurance, rising costs have far outstripped increases in earnings (see chart). This has helped increase the number of uninsured. And for the government, which pays for the health-care costs of many children, the very poor, the retired, veterans and its own servants, the geometrically rising price of cover is inexorably busting the budget. By 2050, says Peter Orszag, director of the Congressional Budget Office (CBO), Medicare (the government programme for the elderly) and Medicaid (for the poor) will together consume some 20% of GDP—almost the same share as the entire federal budget now. Three-quarters of this rise, he says, is due to cost inflation, and only about a quarter to the ageing of America's population.



Mr McCain does not pretend to be able to solve this problem, but he offers a number of mechanisms that will help. The most

important is to shake up the insurance market, by, for instance, allowing health-insurance companies to tout for business across state lines. Insurance and pharmaceuticals companies collectively make some $80 billion a year in profit, which may suggest that there is room for more efficiency.

Mr McCain also wants to see much greater pooling of national data on best practices, a suggestion that chimes with the CBO's finding of vast discrepancies between costs for similar procedures across the country. He wants to see doctors rewarded according to results, rather than procedures, because he argues that the current system is stacked against preventive medicine. His plans are skimpy compared with those of, say, Mrs Clinton. But at least he is asking the right question.

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Divestment

Not with my money

Oct 18th 2007 | NEW YORK
From The Economist print edition

States are divesting from companies investing in Iran

IN 2000 the Supreme Court struck down a Massachusetts law boycotting companies investing in Myanmar, saying it weakened the president's ability to make foreign policy. But states have continued to try to influence foreign policy in other ways. The latest is a boomlet in state laws requiring divestment from Iran.

Federal law has long prohibited Americans from doing direct business with Iran. But many mutual funds and pension funds hold shares in foreign companies, mostly European, that do business there. A campaign called Divest Terror names companies doing business in Iran, and tries to get American funds to pull their investments out of those firms. Many are energy companies, such as Total (French), Statoil (Norway) and PetroChina. Others, like Alcatel, a French telecoms firm, build Iranian infrastructure that has military uses, according to Chris Holton of Divest Terror.

The movement was given a big boost on October 10th when Arnold Schwarzenegger, California's governor, signed a law terminating investment by the state's pension funds in companies doing business with Iran. California was not the first: Missouri's treasury secretary had put her state's money into a “terror-free” fund. But California's size matters—CalPERS, one of its pension funds, is the biggest in the country—and it is inspiring others. Pennsylvania, Michigan, Massachusetts and Georgia are all considering similar bills. Pennsylvania's would divest state funds from all countries listed by the State Department as sponsors of terrorism, including North Korea, Cuba, Syria and Sudan.

The bills have, unsurprisingly, broad bipartisan support. The only sign of resistance comes from fund managers, many of whom say their duty is simply to achieve the best returns. But “terror-free” funds have met or beaten the returns from traditional funds, say their advocates. And the sums pulled out from Iran and others could be large. Pennsylvania's bill alone would pull $10 billion from companies investing in the State Department's list of terror-sponsors.

Despite the political appeal of divestment, it is unlikely to change Iran's behaviour. Daniel Drezner of Tufts University notes that any economic pain caused to Iran will be mitigated by Chinese and Russian companies filling the gap. Besides, if Iran is expecting to fight America one day anyway, economic pressures such as sanctions and divestment offer it little incentive to change its behaviour.

At the federal level, several bills would bolster the states' efforts. One, for example, sponsored by Barack Obama and Sam Brownback (Democratic and Republican candidates for president, respectively), would produce a list of companies doing business with Iran. This would not only have a strong “name and shame” effect on the firms, but would also concentrate the states' efforts. John McCain, a Republican senator and another candidate for president, supports the idea, which he calls the “privatisation” of sanctions. However, the bill has had a “hold” placed on it, an archaic Senate procedure that any senator can use to freeze a bill anonymously.

The hold may be encouraged by the Bush administration, which disapproves of bills like that of Messrs Brownback and Obama. The administration reckons that embarrassing and irritating those companies, and therefore their host countries, undermines its efforts to get those countries onside with broad international sanctions—including, it is hoped, universally binding sanctions from the UN. Unfortunately, there is not much sign of such sanctions being imposed.

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The courts

Bush v Texas

Oct 18th 2007 | AUSTIN
From The Economist print edition

The president sides with a thug

Get article background

THE case, nominally, is *Medellín v Texas*. On one side is the state of Texas. On the other is an odd coalition composed of George Bush, the International Court of Justice (ICJ), and a confessed killer. Now the Supreme Court is being called on to assess various powers: the states', the president's, a treaty's, and its own.

In 1993, during the course of a gang initiation, José Medellín and several other men raped and murdered two teenage girls in Houston. He was convicted in 1994 and sentenced to death. It seemed a straightforward case. He described the crime in grisly detail to members of a co-defendant's family later that evening and signed a written confession a few days later. But there was a complication. Mr Medellín is Mexican. Under the 1963 Vienna Convention on Consular Relations, detained foreign nationals must be notified of their right to speak to consular authorities. The police had not mentioned this to Mr Medellín. He appealed.

America has often ignored this bit of the Vienna Convention. Its neglect had become a sore point with Mexico, which does not support the death penalty. In 2003 Mexico sued America over the issue. In the *Case Concerning Avena and Other Mexican Nationals*, the ICJ ruled that America had violated the rights of 51 Mexicans on death row and ordered that their cases be reconsidered.

Mr Medellín's case had made it up to the Supreme Court by early 2005. That February Mr Bush complicated matters by getting involved, possibly to strengthen his hand against lower courts, or to please the Mexicans. He wrote a memo telling the state courts to comply with the ICJ's ruling. The Supreme Court sent the case back to Texas to see if it could be resolved there. The Texas appeal court decided that *Avena* did not apply. As for the president, several judges agreed that he had “exceeded his constitutional authority by intruding into the independent powers of the judiciary”. Others dismissed it as having been “written in a private memo style”.

The case now rests once more with the Supreme Court, which heard oral arguments on October 10th. If the question was whether Texas has to abide by the ICJ's ruling, matters would be comparatively simple. Justice Ruth Bader Ginsburg, for example, seemed to suggest that the United States would not sacrifice too much sovereignty by abiding by its own treaties. However, Mr Bush's bid for control of the state courts has complicated matters.

A decision is due early next year. A victory for Mr Bush and the internationalists could easily backfire. Mr Medellín strangled one of the victims with her own shoelace. Many Americans would be very unhappy with the idea that an international court could overrule their own courts on his behalf.

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Chicago's police

Breaking the blue wall

Oct 18th 2007 | CHICAGO
From The Economist print edition

In need of reform

THE Windy City's police department has an ugly history. In its most infamous chapter, officers tortured suspects in the 1970s and 1980s. But even with such a past, this year has been particularly fraught for America's second-biggest police force. The police superintendent, Philip Cline, stepped down in April after two videos emerged of off-duty officers beating civilians. Seven members of an elite unit, the Special Operations Section (SOS), face an array of charges including kidnapping, burglary and false arrest, and one officer was accused in September of plotting to kill a defector.

As a whole, Chicago's police are well behaved and effective. The number of murders in the city in 2006 was 44% down on 1995. But the scandals have officials scrambling to restore public trust. On October 9th Dana Starks, the interim police superintendent, announced that he would disband the SOS. On October 15th the Office of Professional Standards (OPS), which investigates police misconduct, issued its first quarterly report. Other recent changes include separating the OPS from the police department. But there is still much work to be done.

Craig Futterman, a law professor at the University of Chicago, wants the OPS to overhaul the way it investigates complaints. Between 2002 and 2004 civilians filed more than 10,000 reports of serious abuse, such as excessive force and false arrests. Only 19 of these complaints led to an officer's suspension for a week or more, he says. Ilana Rosenzweig, the new head of the OPS, is trying to recruit investigators, but her office is understaffed and is dealing with almost 1,300 open cases.

A broader problem is how to change the police department's culture. It is common for police officers to shield each other from punishment, but the phenomenon reaches an extreme in Chicago. Complaints of brutality were 94% less likely to be sustained in Chicago than in other large police departments in 2004, Mr Futterman reports. Federal prosecutors are now investigating whether any commanders knew of the SOS debacle, but failed to stop it.

Breaking this code of silence might best begin with a strong new police superintendent. But the city is searching high and low for someone to replace Mr Cline. However, the next police chief, whoever he may be, cannot expect an overnight fix. Take Los Angeles. Since 1991, when police were taped beating Rodney King, the city has seen a wearingly repeating pattern of scandal and reform. (On October 9th investigators released their latest report, about police using excessive force against protesters and journalists in May.) If Los Angeles is any indication, Chicago's current wave of reform will not be its last.

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Native Americans in Washington

An inconvenient hunt

Oct 18th 2007 | SEATTLE
From The Economist print edition

Animal-lovers clash with ancient customs

ON SEPTEMBER 8th, five members of the Makah Indian tribe on Washington state's north-west coast harpooned, then shot dead, a North Pacific grey whale. The Makahs last killed a whale in 1999, after regaining a treaty right to do so that had been lost for some 70 years. But the September hunt was illegal, violating a federal court's 2002 order demanding that the Makahs get a waiver to the Marine Mammal Protection Act before killing another whale.

Early in October prosecutors in Seattle indicted the five hunters. They could spend a year in jail and pay fines of $100,000 each. But although the illegal hunt may complicate the Makahs' wish to resume legal whale hunting, within two years they will probably get the waiver they want.

Yet that does not resolve the larger question: what should non-Indians make of whale-killing? It's a “senseless slaughter,” wrote one reader to the *Seattle Times*. “What type of culture needs a machinegun to kill a defenceless animal?” added another. America is generally a land of animal-lovers. After the televised death of a meerkat in a popular wildlife show was shown recently, the show's office was swamped by grief-stricken notes.

The trouble is that conservationists view animals in a fundamentally different way to the Makahs. Ted Fortier, an anthropologist with Seattle University argues that non-Indians tend to think about animals as individuals, while Native Americans see a whale or a bear or an eagle more as part of a greater whole. “They see it as part of a whale ‘spirit', not an individual whale—and that's a hard thing for Westerners to understand,” Mr Fortier says. So killing a single whale, according to the Makahs, does no harm to the greater population.

Still, if tribal members really wanted to move their case forward in the court of public opinion, they didn't do well on October 12th when the five hunters appeared in court. “Of course I'm not guilty,” one told a reporter before the hearing. “I have a treaty right.” True enough. But in the complex and often strained web of relations between “Indian country” and the outside world, a little less defiance might have been helpful.

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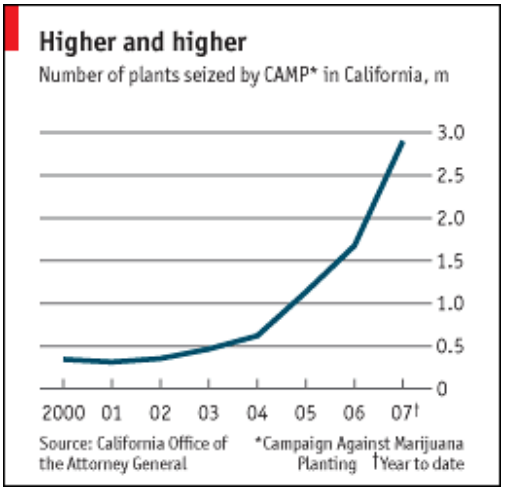
Marijuana

Home-grown

Oct 18th 2007 | CHINO HILLS
From The Economist print edition

Forget wine—California's biggest crop is bright green and funny-smelling



SUBURBS don't come much tidier than Chino Hills, 30 miles (50 km) east of downtown Los Angeles. Last year, the neighbourhood of coffee-coloured stucco houses and three-car garages boasted an average household income twice that of the nation as a whole. In Vista del Sol, one of its quiet enclaves, every house but one has a neatly-trimmed green lawn. And, until recently, the exception was verdant inside. When the police went in, they found more than 800 marijuana plants—a small part of what is turning out to be an enormous harvest.

Greg Garland, a local narcotics cop, used to discover about a dozen houses a year that had been turned into marijuana factories. So far this year he has raided more than 40. The production boom is not confined to the suburbs. Since April the state's annual "Campaign against Marijuana Planting" has pulled 2.9m plants worth some $10 billion from back gardens, timber forests and state lands (see chart). Marijuana is now by far California's most valuable agricultural crop. Assuming, very optimistically, that the cops are finding every other plant, it is worth even more than the state's famous wine industry.

The illicit crop is grown with a technical sophistication that Napa Valley's Robert Mondavi might envy. To supply outdoor plantations, rivers are dammed and water piped as far as two miles. Plants are nourished with fertilisers and tended by workers brought to America specifically for the purpose. Ageing hippies are responsible for only a few such operations. Kent Shaw, a state narcotics officer, reckons four-fifths of outdoor marijuana plantations are run by Mexican criminal gangs.

Indoor factories, by contrast, are largely the province of East Asian entrepreneurs. They prefer to buy houses rather than rent them, to avoid the attention of landlords. They tend to go for big ones in good neighbourhoods: the property in Vista del Sol cost more than $600,000. Like good horticulturalists, they propagate strains of the plant that produce a high proportion of tetrahydrocannabinol (THC, marijuana's active ingredient) and speed their growth by means of heat and artificial light.

Why the boom? The National Survey on Drug Use and Health shows that the rate of marijuana use in California has barely risen in the past few years, whereas production has hugely increased. Some 11% of the state's population indulge—just a puff over the national average, and less than every state in New England.

The likely explanation is a steady tightening of America's borders after the terrorist attacks of September 11th 2001 and the panic over illegal immigration. California used to import high-grade marijuana from Canada and low-grade weed from Mexico. Both routes are now more risky. As a result, Asian gangs have moved south from British Columbia, where they dominate the hydroponic trade. Mexican distributors, who may handle cocaine and methamphetamine as well as marijuana, have diversified into production.

In places like Chino Hills, the boom has also been helped by demographic change. Like many southern California suburbs, Chino Hills has been rapidly transformed from a mostly white area to a rainbow one. Residents of such a diverse place may be more inclined to ignore odd behaviour and a funny smell emanating from the house down the road—provided that the grass is kept short.

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The homeless

Not always what they seem

Oct 18th 2007 | MINNEAPOLIS
From The Economist print edition

New thoughts on an old problem

THE queue, which began forming hours before the doors officially opened, stretched across the lobby and onto the pavement in front of the downtown convention centre. More than 1,800 people—bantering groups of friends, loners, shell-shocked veterans and weary single mothers—turned up recently for an event dubbed Project Homeless Connect. It offered needy people everything from job applications and educational assistance to haircuts and a hot lunch. In return, attendees were asked to provide data on themselves and their living circumstances, all of which were fed into a local database. Some of the attendees seemed strangely out of place. A well-spoken, middle-aged woman with freshly manicured nails said she had a college degree and had held a series of steady jobs, but had fallen on hard times recently.

AP

New ideas needed

Homelessness is not an issue normally associated with places like Minneapolis. This city is relatively prosperous, has cold winters and is in an overwhelmingly white, northern state. But homelessness has moved up the agenda for many American mayors in the past couple of years. With property foreclosures surging, homeless advocates worry that the problem will grow. They also voice concerns about the number of returning veterans with brain injuries and post-traumatic stress disorder.

Big cities have long grappled with the issue, and say they are making progress. San Francisco was in the news this month for sending teams of social workers, psychologists and police on a sweep for homeless people. Places as diverse as Nashville, Anchorage and Cedar Rapids, Iowa, have adopted ten-year plans aimed at eliminating long-term homelessness.

Several factors are driving the movement. The first is a better understanding of the homeless population. Despite the perception that it consists mostly of single men with drug, alcohol or mental-health problems, the majority are families, singles or young people who simply cannot afford housing, says Nan Roman at the National Alliance to End Homelessness. The group reckons that 600,000 families with 1.35m children experience homelessness each year, accounting for about half of the national total. Many are in dire need for a relatively short time, living in shelters for just days or weeks. But research shows that a hard core—some estimates put it at about 10% of the total—is chronically homeless.

With better understanding of the group's diversity, new approaches are being used. Much current thinking about homelessness is based on the work of Dennis Culhane, currently at the University of Pennsylvania, who followed thousands of homeless people in New York several years ago. Each of them used up an average of $40,000 a year in public services, such as hospital care and jail time. When half of the group was offered public housing (coupled with services such as counselling) that group's time in

hospital and prison fell dramatically. The net result was a big improvement in the problem at little extra net cost.

About 40 communities around the country have since attempted to emulate the scheme. The approach is also backed by Philip Mangano, who heads the Interagency Council on Homelessness, a federal body.

All this is a departure from traditional means of dealing with the homeless, which Mr Mangano says are either too soft or too tough. Some communities, he admits, are still using heavy-handed police tactics. “The punitive approach has never worked anywhere,” he says. Instead, it simply tends to shuffle the homeless out of sight for a month or two.

Nevertheless, the police have an important role to play in preventing crimes against those living on the streets, he says. Violent crimes against the population have shot up in the past year, including some horrifying cases. In Spokane, Washington, a one-legged homeless man was set on fire in his wheelchair and died of his burns. Current approaches to homelessness may not eliminate such atrocities, but the new focus on the problem is a start.

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Lexington

Gore the pure

Oct 18th 2007
From The Economist print edition

Illustration by Kevin Kallaugher

Nobel laureate Al Gore is unlikely to run again. His ideas are catching on, but people still don't want to pay for them

THE last eco-warrior to win the Nobel peace prize, Wangari Maathai (a tree-planting conservationist who won in 2004), was barely known outside her native Kenya. Al Gore is a flashier shade of green. His trophy cabinet is already bulging—the Nobel medal will have to jostle for space with an Oscar and an Emmy, all won this year. His political career has probably attracted more attention than that of any other living non-president. Billions watched the drama of Bush v Gore unfold in 2000. So last week's announcement in Norway has naturally ignited speculation that Mr Gore will mount another bid for the White House.

Don't hold your breath. As Mr Gore well knows, running for president is not much fun. You have to make small talk with thousands of people you don't know. You are attacked often, viciously and sometimes unfairly. And you have to forgo that comforting extra scoop of ice-cream. Why would Mr Gore re-subject himself to such an ordeal? Currently, as the prophet of the planet's most fashionable cause—preventing climate change—he is showered with adulation wherever he goes. The more the world recoils from George Bush, the more it embraces the man he beat (or didn't, if you believe some diehard Gorephiles). Mr Gore advocated tackling global warming and staying out of Iraq before either cause was popular in America. Foreigners love him. So do Democrats.

But were he to heed the 200,000 petitioners who have signed up at www.draftgore.com, he would lose his saintly aura. He would have to raise money and trash his opponents again (it was he who first attacked Michael Dukakis for freeing violent jailbirds for the weekend). His tendency to over-dramatise the likely consequences of climate change—will the oceans rise by two feet or 20?—would be ruthlessly pilloried. Worst of all, he would probably lose again. A Gallup poll taken after the Nobel announcement found that if he ran for the Democratic nomination, Hillary Clinton would thrash him by 30 points and Barack Obama would pip him by five. Only 48% of Democrats said they wanted him to run—six points less than seven months ago. Mr Gore has repeatedly, though not absolutely definitively, said he is not planning to run, and did so quite firmly again this week. The chances must now be remote that he will change his mind.

Far more likely is that Mr Gore will carry on as before, agitating from outside the political system for America to emit less carbon. He may succeed. The Senate will soon consider a bill, co-sponsored by Mr Gore's former running mate, Joe Lieberman, to set up a cap-and-trade system for greenhouse-gas emissions. Similar proposals are working their way through the House of Representatives. If both arms of

Congress present Mr Bush with a cap-and-trade bill, he may well sign it. If none of this happens before next year's election, it will probably do so afterwards.

Turning up the heat

Public opinion is shifting. The proportion of Americans who say they worry “a great deal” about global warming has risen from 28% to 41% in the past four years. Over the same period, the proportion favouring “immediate, drastic action” to protect the environment has risen from 23% to 38%. How much of this is due to Mr Gore is impossible to say. Others crunched the numbers (including the UN's Intergovernmental Panel on Climate Change, with which he shared the Nobel). Hurricane Katrina, some reckon, did more than Mr Gore to make Americans fear global warming. (Illogically, since one storm proves nothing.) And Mr Gore's political past sometimes hinders his message. Granted, many Americans take him more seriously because he used to be vice-president. But others dismiss him because he was part of an administration that often twisted the truth. Nearly half of Republicans think the environment is in good shape; only 9% of Democrats agree.

Despite all these caveats, Mr Gore has surely helped to pave the way for American action against climate change. American voters are hardly demanding such action—only 2% say that climate change is one of the most important issues they will take into account when voting next year. But all the main Democratic candidates favour a cap-and-trade system. They also favour auctioning the emissions permits rather than giving them away. Mr Obama uses religious language to make the case, arguing that “we are not acting as good stewards of God's earth.” On the Republican side, John McCain has long pushed for cap-and-trade. His main rivals have not so far felt pressed by their Republican electorate to say much about it. But whoever clinches the nomination will be forced to take a stance.

Besides Mr Gore, however, no plausible candidate of either party favours a carbon tax, the most efficient way to tackle emissions. (Chris Dodd, a Democrat, does, but he surely won't win.) Voters prefer solutions that are either cheap or that they think will be paid for by someone else. A poll for the *New Scientist* magazine in June tried to quantify this, with sobering results. Only half of Americans would favour rules to force power companies to emit less if that raised their monthly electricity bill from $85 (the average in 2005) to $155 (an estimate of the hike needed to lower American emissions by 5% by 2020). And only 37% could stomach a tax that raised petrol (gasoline) prices to $4 a gallon. That would be an unprecedented hardship for Americans but barely half what the stuff now costs in Britain.

This is why Mr Gore talks more bluntly now than he ever did on the campaign trail, and why no serious presidential contender echoes him. You cannot win the White House by telling Americans that they must pay more to drive, or by telling Midwestern coalminers that their industry must clean up or die. But if candidates do not prepare America for the cost of tackling climate change, the next president will have no mandate to impose it. Now that's an inconvenient truth.

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Argentina's presidential election

Cristina, a familiar enigma

Oct 18th 2007 | BUENOS AIRES
From The Economist print edition

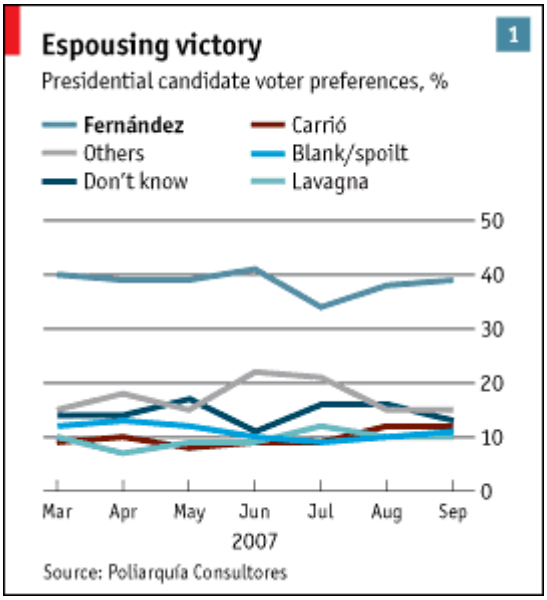
Reuters

The president's wife seems certain to succeed him, but will she cool an overheating economy?

Get article background

ABROAD she is sometimes compared to Hillary Clinton. At home she likes to invoke Eva Perón. Either way, Cristina Fernández de Kirchner seems certain to win Argentina's presidential election on October 28th, and thus to succeed her husband, Néstor Kirchner. If the polls are to be believed, she will win by a large enough margin to avoid the need for a run-off ballot (see chart 1).

If so, she will become the first woman to be elected as Argentina's president. (Isabelita, Juan Perón's third wife and his vice-president, briefly succeeded her husband before being ousted by a military coup in 1976.) She likes to point out that she has been a senator since 1995 and so was a national political figure when her husband was a mere provincial governor. But assuming she wins, she will owe her victory to his—or their—decision that he would not seek a second consecutive term and that she would run in his stead.



Mr Kirchner has presided over Argentina's vigorous recovery from a horrendous economic, financial and political collapse in 2001-02. Thanks to four years of annual economic growth of over 8%, poverty and unemployment have halved since he took office in 2003 (see chart 2). For that, the president can take only some of the credit. He inherited a capable economy minister in Roberto Lavagna, who had put in place some coherent policies. Idle factories whirred back into action while world prices climbed for Argentina's farm exports.

But Mr Kirchner's brutal treatment of holders of some $81 billion in bonds on which Argentina defaulted in 2001 ensured that debt payments did not become a drag on growth. He quelled a riotous movement of unemployed protesters with a mixture of handouts and diatribes against the IMF, big business and the privatisations conducted by Carlos Menem, a right-wing Peronist, in the 1990s.

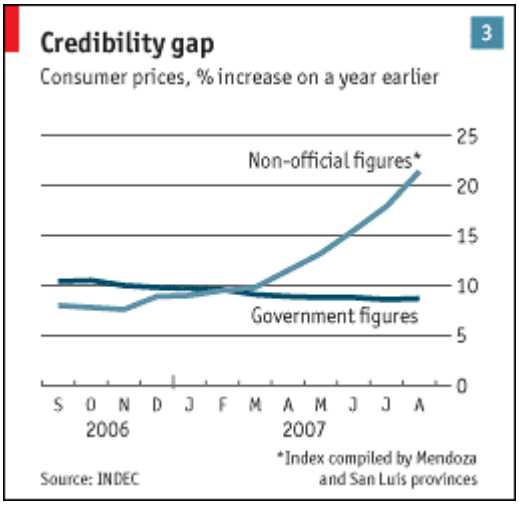
After winning control of Congress in a mid-term election in 2005, Mr Kirchner dumped the prudent Mr Lavagna. Since then, he has deliberately allowed the economy to overheat. Interest rates are

negative in real terms, while the government has opened the fiscal tap (so far this year central-government current spending has risen by an eyepopping 48% in nominal terms). As a result, inflation is rising fast.

The government has responded with price “agreements” (ie, controls) and blatant manipulation of the official inflation index. The real figure, suggested by the numbers published by two provinces, may be up to twice the official one (see chart 3). Similarly, Mr Kirchner's populist approach to energy—energy prices in Argentina are only 60% of those of its neighbours—has led to occasional shortages. Meanwhile, his government has been hit by several corruption scandals this year.

Nevertheless, Mr Kirchner is still popular—more so than his wife. So why did he decline to stand for re-election himself and impose his wife as the Peronist candidate? He has never fully explained. Some opponents reckon that his intention is to return in four years' time, thus prolonging the family hold on power. Insiders say that he believes that Ms Fernández's skills are better suited than his own to the tasks now facing the country. “She can sit down and bargain without having been the person who screwed over anyone,” says an official who is close to her.

Ms Fernández has given little away about her intentions. She has maintained a big lead in the opinion polls while doing little campaigning. Like Mr Kirchner, she does not submit to press conferences or interviews by Argentine journalists. She has spent much of the past few months travelling abroad—something her husband has done very little. She has unveiled few policy plans and held few rallies.



But she is a better public speaker than Mr Kirchner, feisty and articulate where he is awkward and uncommunicative. “I identify with the Eva Perón who clenched her fist at the microphone, not with the...good fairy who arrived with Perón to hand out work and [women's] right to vote,” she told *El País*, a Spanish newspaper. But some Argentines say she lacks the common touch of the always-remembered Evita. Of middle-class background, Ms Fernández and Mr Kirchner met at university, and worked as property lawyers in Santa Cruz, the Patagonian province of which he became governor. Nowadays Ms Fernández sports designer handbags, trademark white suits and, it is said snidely, collagen-enhanced lips.

That she has not been pressed harder in the campaign says much about the hapless opposition. The Radical party, the traditional opposition to the dominant Peronists, had the misfortune to hold (and lose) power during the economic collapse of 2001. Even though they were implementing Mr Menem's policies, Argentines blamed the Radicals rather than the Peronists for the debacle. The party has shrunk and splintered: Julio Cobos, a Radical who is governor of Mendoza province, is Ms Fernández's running mate.

Her main rivals are Mr Lavagna, who presents himself as an “alternative” to (rather than an opponent of) the Kirchners, and Elisa Carrió, a former Radical who offers little except a campaign against corruption. Several others have struggled to break into double figures in the polls.

Ms Fernández not only basks in her husband's popularity. She enjoys some of the advantages of incumbency. She has use of the presidential jet and friendly coverage on state television. Her opponents say they have had trouble raising money because some would-be donors have held back for fear of a punitive tax audit. The opposition's divisions also help her: she can avoid a run-off provided she gets 40% of the valid votes and leads her closest rival by ten points.

Assuming she wins, will Ms Fernández's policies differ from those of her husband? Her political views, like Mr Kirchner's, were forged in the Peronist left of the 1970s: nationalism, a sizeable state role in the economy and hostility to the armed forces. But aides point to differences of emphasis and experience. Ms Fernández has been her husband's de facto floor leader in Congress over the past four years. Unlike him, she is a negotiator, they say.

While Mr Kirchner's opponents accuse him of autocratic tendencies, Ms Fernández's defenders present her as a champion of democratic institutions. On that, however, there are disagreements. She championed bills to give the presidency control over judicial appointments, and to reallocate congressionally-mandated spending at will. Yet she also supported moves to reform the Supreme Court that have the backing of NGOs.

The clearest difference is in foreign policy. Mr Kirchner showed no interest in it, beyond an alliance with Venezuela's Hugo Chávez, whose government has bought some $5 billion in Argentine bonds and has swapped diesel fuel for farm machinery and other products. On her trips abroad, Ms Fernández has courted businessmen. She is likely to seek better relations with the United States and Europe, but without breaking with Mr Chávez. She has said she plans to renegotiate the $7 billion that Argentina owes the Paris Club of rich-country lenders—but rejects the club's requirement that the IMF be involved. It is not clear whether she would seek to ease Argentina's access to world financial markets by reaching a deal with the holders of bonds (worth $20 billion at face value) who did not accept the debt restructuring.

One big doubt is whether she will take the steps, eschewed by Mr Kirchner, needed to engineer a soft landing for the economy. Once inflation exceeds 20% and energy rationing reaches homes, Argentines will surely demand solutions to these problems. But these involve unpopular measures for which the public has not been prepared. If inflation is to be curbed, rather than covered-up, interest rates will have to rise, the growth of public spending will need to be checked, and the peso be allowed to appreciate. Energy tariffs will have to rise, some of them steeply.

A second doubt concerns Mr Kirchner's role—assuming it is his wife to whom he passes the presidential sash on December 10th. He has vowed to remain in politics; although Peronism is a mosaic of warring factions, he controls its most powerful political machine. So Argentines will be in little doubt that if they vote for Ms Fernández they will be getting two Kirchners for the price of one—a somewhat inflated price, opponents would doubtless say.

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Brazil

Highway to somewhere

Oct 18th 2007 | SÃO PAULO
From The Economist print edition

The private sector revs up its bulldozers

AFTER years of hesitation, and more than one false start, on October 9th Brazil's government finally held an auction in which private companies bid for the right to improve and maintain 2,600km (1,600 miles) of roads. Among Brazil-watchers there was widespread agreement that this was a milestone: here was the country's president, Luiz Inácio Lula da Silva, who had once advocated re-nationalising anything that whirred, embracing the market and bringing much-needed investment to Brazil's creaking infrastructure.

OHL, a Spanish company that won five out of the seven contracts on offer, expects to invest 3 billion-4 billion reais ($1.6 billion-2.2 billion) over the next five years on toll roads running from São Paulo north to Belo Horizonte and south to Curitiba and Florianópolis. The winning bidders were those who offered to charge the lowest tolls over the 25-year life of the contracts.

This investment is overdue. While exports have been booming, Brazil has not built much in the way of roads, ports or airport runways for the past 15 years. It is not unusual for ships to have to wait outside big ports, such as Santos, for up to two weeks before being allocated a slot to dock and unload. An aerial film of Brazil just after the soyabean harvest would show a collection of some of the longest traffic jams on earth.

High commodity prices have masked some of the impact of these shortcomings on the economy. Some companies have found ways around the problem: CVRD, a giant mining firm, has its own railway and port. Even so, the congestion means Brazil is poorer than it ought to be.

Earlier this year Lula unveiled an ambitious plan to increase public investment in infrastructure over the next three years. He was given a gruesome reminder of the urgency of the problem in July, when a passenger plane slithered over the end of a short and recently repaired runway at Congonhas, São Paulo's commuter airport, killing 199 people.

So far the money promised has not materialised. The federal government will spend no more than 0.9% of GDP on public investment this year, reckons Alexandre Bassoli, an economist at HSBC Brazil. Unless that figure rises to at least 1.5%, he adds, Brazil can expect electricity rationing to return (it suffered this in 2001) shortly after 2010. Public-sector pensions, by comparison, gobble up 11% of GDP.

The private sector could build more of what is needed, given the chance. The auction attracted bids from a consortium backed by Goldman Sachs, an American investment bank. Odebrecht, a big Brazilian construction company, has raised $200m for infrastructure projects through a bond issue that was so popular that it could have been sold six times over.

Until now, a big stumbling block has been the government's failure to reassure private investors that regulatory agencies set up during the 1990s are still fully independent. Still, for a few hundred kilometres at least, the traffic should soon start moving.

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Canada

Truth or dare?

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A minority government looks ahead

Reuters

Harper lightens up

WHEN Stephen Harper's Conservatives formed a minority government after an election in January 2006 turned them into the largest party in the House of Commons (they have just 126 of its 308 seats), they did not expect to be in power long. Mr Harper set five minimalist policy priorities and rattled through them before the government might fall. But 20 months on, he is still prime minister. On October 16th his government set out a rather broader agenda in the throne speech at the start of the parliamentary year. But will it have the time to carry this out?

Mr Harper, a stiff, solemn but practical politician, says he would like to carry on for two more years before calling an election. He promised tax cuts; a new set of policies for northern Canada, aimed at buttressing a claim to sovereignty over Arctic waterways; fresh talks with the provinces on spending and regulation; new crime bills; Senate reform; and an environmental bill. He also said that Canadian troops might stay longer in Afghanistan (see article).

To some opponents, this shopping list smacked of a campaign manifesto for a snap election, rather than a programme of government. Leaders of the separatist Bloc Québécois (49 seats) and the leftist New Democratic Party (30 seats) both said they will vote against the throne speech. But it is the Liberals, with 96 seats, who hold the key to the government's longevity. Their newish leader, Stéphane Dion, said his party would abstain in votes on the speech because “Canadians don't want another election right now”.

There is some truth in that. The 2006 federal election was the second in less than two years. This year there have been provincial votes in Quebec, Ontario and Newfoundland, with another to come in Saskatchewan (and possibly Alberta). More importantly, the Liberals are in disarray (see article). They trail the Conservatives in the opinion polls, especially in Quebec, Mr Dion's home province. The party's national director was forced out after an injudicious remark was interpreted as racist by some in Quebec. The head of the Quebec Liberals left after a supposedly star candidate was drubbed in a Montreal by-election last month.

There was also little in the government's plan for the Liberals to seize on as a pretext for an election. The prime minister deftly blunted opposition to his Afghanistan policy by appointing a Liberal to chair a committee to consider alternatives. Similarly, it is difficult to oppose the government's environmental policy until it becomes clear exactly what legislation will be pursued. The fact that Canada will not meet the greenhouse-gas emissions targets it agreed to under the Kyoto protocol, a pact that Mr Dion firmly supports, is now old news.

In the end, the stiffest resistance to the government's new agenda may come from provincial premiers. They are wary of the federal government's intention to force them to dismantle internal trade barriers. Still, while the premiers can make life rough for the federal government, only the opposition in Ottawa can bring it down. They have been in a position to do so for 20 months and will have more chances in the weeks ahead. “I'm in no hurry,” Mr Harper said recently, when asked whether he wanted an election. But neither, it seems, are the Liberals.

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Canadian political memoirs

The pen as dagger

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Those not so nice Canadians

BETWEEN them Brian Mulroney, a Conservative, and Jean Chrétien, a Liberal, governed Canada for almost two decades until 2003, a period of sweeping changes. But in their respective memoirs, published within days of each other this autumn, the main revelations concern the depth of their loathing for their political opponents. The difference is that in Mr Chrétien's case these were in his own party.

In a story that echoes the rivalry between Britain's Tony Blair and Gordon Brown, Mr Chrétien, a skilful political operator, blames Paul Martin, his successful finance minister, for forcing him out of office. Mr Chrétien savages his successor for over-reacting to a scandal over a government marketing campaign by appointing a public enquiry rather than treating it as a police matter. He believes that this unfairly dragged his people through the mud as well as losing the Liberals the 2006 election. He also blames on Mr Martin's dithering the relocation of Canadian troops in Afghanistan from the relative safety of Kabul to the killing fields of Kandahar.

The book will do nothing to close the rift that still splits the Liberals—especially since Mr Martin is working on his own memoirs. By contrast, in 1,054 pages Mr Mulroney has little to say about Stephen Harper, Canada's current prime minister, even though he was a prime mover in Reform, a splinter party which divided Canadian conservatism for a decade. Mr Mulroney is an increasingly influential backroom adviser to Mr Harper. That may be good politics, but it makes for blander reading than Mr Chrétien's vitriol.

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Pakistan's political mess

BB's back

Oct 18th 2007 | KARACHI AND LARKANA
From The Economist print edition

AFP

Benazir Bhutto mustered a big crowd for her homecoming in Karachi. What happens next in Pakistani politics is anyone's guess

TO THE adoring clamour of hundreds of thousands of her supporters gathered in Karachi—and as many groans across the country—Benazir Bhutto, a former prime minister, returned to Pakistan on September 18th after an eight-year self-imposed exile. “This is not just a journey for me,” she declared before landing, “but the beginning of a journey for the people of Pakistan for a better future.” She sobbed on the runway. A huge bullet-proof lorry, known as the “BB-mobile”, was waiting to ferry her to the tomb of the country's founding father, Muhammad Ali Jinnah.

This opens a new chapter in Pakistan's political thriller. The main plot features a hated ruler, General Pervez Musharraf, battling an array of challengers: lawyers, incensed by the constitutional vandalism behind his eight-year rule; Taliban militants fighting his army; and civilian politicians whom he had co-opted or banished. In her crowd-pulling ability, Miss Bhutto, head of Pakistan's biggest political party, is the most formidable of them all.

Yet to some Pakistanis she is less a challenger than a lackey. She has been negotiating with General Musharraf to share power. In this process, he this month granted Miss Bhutto (and others) amnesty from corruption charges relating to her two terms as prime minister—and so smoothed her way home. He also pledged to resign as army chief, as Miss Bhutto and the constitution demand, before November 15th when, all being well, he will be sworn in for another five-year term as president. On October 6th, still in uniform, he had himself re-elected to this post by an electoral college of Pakistani lawmakers. Every opposition party quit parliament in protest, except Miss Bhutto's Pakistan People's Party (PPP).

Despite all this, General Musharraf and Miss Bhutto still do not have a deal. The general has not yet met some of her demands, including measures to help ensure a fair election—for example, by suspending corruptly elected pro-government mayors. One reason is that the general's re-election is itself still in doubt. On October 17th the Supreme Court began hearing a legal challenge to it. The court was also due to rule on a challenge to the legality of Miss Bhutto's amnesty. Pending these rulings, General Musharraf and his prime minister, Shaukat Aziz, urged Miss Bhutto to delay her return. Instead, she has gambled that it will generate enough popular support to win her a better deal from General Musharraf, or perhaps not to need one.

Miss Bhutto's reception in Karachi—the capital of her native Sindh province—was a crucial first test. Its

organisers did their work well: if there is no such thing as a free crowd in Pakistani politics, the one in Karachi was unusually pricey. For over a week thousands of billboards along the 16km (10 mile) route that Miss Bhutto's “caravan of democracy” was to take had been rented by PPP supporters to advertise the event. “Welcome homeland Benazir!” was a poem emblazoned on one of them.

To import the requisite flag-wavers from the party's strongholds in rural Sindh and southern Punjab, thousands of buses were hired. The driver of one parked outside Karachi airport, Sajjad Hussain, said he had come from Punjab province in a convoy of 100 buses. A local doctor, who is seeking a PPP ticket in the election, hired his bus for 75,00 rupees ($1,250). Over 500 buses were reported to have come laden from Miss Bhutto's hometown of Larkana, in northern Sindh. Asked who was footing the bill, the PPP's leader in Sindh, Nisar Ahmed Khuhro, grimaced: “We are, I am, tax-paid—we love it!”

It was a wise precaution. As the gold standard of political homecomings, Miss Bhutto's supporters had her previous return from exile, in 1986, to aim at. On that occasion, with much less encouragement, some 750,000 people welcomed Miss Bhutto to Lahore. She had come to challenge the dictator, General Zia ul-Haq, who had hanged her father, a populist former prime minister, Zulfikar Ali Bhutto. Now, however, Miss Bhutto comes as a failed former prime minister, accused (but not convicted) of grand-scale thieving.

The Musharraf effect

Her recent dealings with the general have also hurt her. A poll for the International Republican Institute (IRI) showed that the proportion of Pakistanis who consider her their best leader has dropped to 28% in recent months. Support for Nawaz Sharif, another exiled former prime minister, who has refused to talk to General Musharraf and who briefly returned to Pakistan last month, has climbed to 36%.

Even in Larkana, Miss Bhutto's fan-base needs priming. A dusty town, ringed by green orchards watered from the Indus river, it is festooned with welcoming banners and billboards. More solid reminders of what PPP rule means to the town are also on display: the cancer hospital and library built under Zulfikar Ali; the children's hospital built under Benazir. Yet in 2005, albeit under pressure from General Musharraf's agents, the city council elected a Musharraf loyalist as mayor.

General Musharraf is horribly—perhaps irredeemably—unpopular. The IRI poll gave him a 21% approval rating—down from 63% a year ago. Whether this represents an opportunity or a cost for Miss Bhutto is unclear. The answer will depend on the terms of any deal with the general. This, in turn, hinges on how Pakistanis respond to Miss Bhutto in the weeks ahead. And it may depend also on the fate of Mr Sharif, whose proxies predicted this week that he would return to Pakistan to fight the election. The government last month sent him to exile in Saudi Arabia, in defiance of a Supreme Court ruling, and says he cannot return.

In Larkana, in this time of flux, Miss Bhutto's estranged uncle and political rival, Mumtaz Ali Bhutto, stands as a symbol of the political status quo. On the forecourt of his splendid hacienda, surrounded by his family's 10,000 acres of land, he says of his niece's putative deal-making: “It's disgraceful and any government that emerges from it won't last six months. Then we'll have another military dictatorship.” Meanwhile, in a courteous and time-worn ritual, he beats off a large crowd of his followers, as, one by one, they line up to clasp his knees.

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China

The mysterious Mr Hu

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Less bellicose than his predecessor, but no more democratic

HE HAD been China's Communist Party chief for five years and state president for four, but it was not until October 15th that Hu Jintao made his first televised address explaining what his policies were. Mr Hu suggested ways China could become more democratic and less corrupt. He called for peace with Taiwan. But Mr Hu showed no zeal for bold reform.

The occasion for Mr Hu's speech was the start of a week-long party congress in Beijing, shortly after which big changes in the top leadership will be announced. But Mr Hu is no more a strongman than he is a visionary. The new line-up is likely to be a compromise between rival factions that leaves the succession uncertain.

Reuters

Things looking up for Tibet?

When Mr Hu took over as party chief just after the last congress in 2002, optimists speculated that he might prove bolder than the previous paramount leaders, Jiang Zemin and Deng Xiaoping, in pushing for political reform. After Mr Hu's 2½-hour speech, China's state-owned news agency noted that he had used the word democracy more than 60 times. But Mr Jiang mentioned the word almost as often in 2002. Politically, little has changed.

Mr Hu's speech offered scant hope that it would in the next five years either. He spoke of the need for more transparency and greater public participation. But he offered few concrete suggestions for achieving this, such as strengthening China's largely ceremonial legislature. Nor, it seems, will he shed more light on his own doings. (He has yet to hold a proper news conference.) Mr Hu called for more democracy inside the party itself, including a system whereby local party committees would vote on important issues and personnel appointments. Voting, however, is time-honoured party practice. It has mastered the art of rigging.

Democrats in Hong Kong were not inspired. Mr Hu made no mention of their demands for (and China's neglected promise of) a chief executive and legislature chosen by universal suffrage. Hong Kong's present chief executive, Donald Tsang, caused a furore this month by saying that democracy, taken to “the extreme”, could result in something like the Cultural Revolution in China in the 1960s and 70s. It is an argument often made by Chinese officials to deter demands for democracy. Mr Tsang, however, was forced to apologise for his remarks the next day.

Despite China's deep misgivings about democracy in Taiwan, Mr Hu surprised some observers by striking a relatively conciliatory note on the island, which China regards as its own. China is alarmed at plans by Taiwan's president, Chen Shui-bian, to hold a referendum seeking support for Taiwan's doomed attempt to join the United Nations as “Taiwan” rather than “the Republic of China”, the name under which it lost its UN seat in 1971.

Both China and America have described the vote as a step towards a declaration of independence by Taiwan, an act that China has said would trigger war. But Mr Hu, unlike Mr Jiang in 2002, made no mention of the use of force. He repeated an offer for a peace agreement with Taiwan, if it accepts the idea of “one China”. He also failed to repeat Mr Jiang's warning that “the Taiwan question must not be allowed to drag on indefinitely”. Mr Hu seems more content than was his predecessor to ignore Taiwan, as long as it does not explicitly renounce its notional links with the mainland.

In the build-up to the Olympic games next August, Mr Hu is anxious to avoid confrontation abroad. He made ritual mention of “hegemonism”, party-speak for American dominance, a couple of times in his speech. But he said progress towards a “multipolar world” was irreversible. This implies China is now more

confident that its rise as a global power will not be blocked by America.

Mr Hu would not have surprised his audience of more than 2,200 delegates had he sounded tougher on the Americans. Chinese officials have been seething over Congress's decision to award a Gold Medal of Honour to the Dalai Lama, and President Bush's decision to attend the ceremony on October 17th. This was the highest-profile meeting between an American president and the exiled Tibetan leader. China responded by pulling out of talks involving America and others due to be held in Berlin this week over the nuclear crisis in Iran. American officials expect China's pique to be short-lived, however. Mr Hu is delighted that Mr Bush will attend the opening of next year's Olympics.

Despite intense jockeying for power in the build-up to the party congress, no sign has emerged of any serious policy differences between the two men tipped to emerge as the top contenders for Mr Hu's job in 2012. Both Xi Jinping, the party chief of Shanghai, and his counterpart from Liaoning Province, Li Keqiang, have been dutifully parroting Mr Hu's line.

Perhaps with the top party job in mind, Mr Xi, 54, has gone to unusual lengths to make his agenda known. Earlier this year the Chinese Academy of Social Sciences published a six-volume work describing reforms in Zhejiang, a relatively prosperous coastal province, where Mr Xi was party chief for five years before taking up his post in Shanghai in March.

In the volume on political reforms, the authors note that Zhejiang's wealth has produced growing demands for political participation. This “increasing democratic consciousness”, they say, calls for new trails to be blazed in political reform. Mr Xi, claims the book, has obliged. It gives details of recent experiments with grassroots democracy in Zhejiang, from public discussions of local policies to village referendums. It suggests that local governments at all levels should carry out such trials. Never mind if some turn out to violate central policy, the provincial leadership can always put a stop to them.

But multiparty democracy is no more on Mr Xi's mind than it is on Mr Hu's. The books describe Zhejiang's vigorous efforts to develop party cells in private enterprises and recruit private-business owners (19,682 of them were members by the end of 2005). Even in a booming region like Zhejiang, where non state-owned enterprises produced 65% of GDP by the middle of the decade, the party's grip on power remains “as solid as a rock”, the authors proclaim. If so, Mr Xi has a bright future.

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Japanese politics

Uncharted waters

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A fight about Japan's role in the world masks a different political struggle

Reuters

IN JAPAN'S ruling party, says Taku Yamasaki, a former secretary-general, “we feel a tremendous pain, to the marrow of our bones.” The reason is the loss by the Liberal Democratic Party (LDP) in summer elections of the upper house of the Diet (parliament). The LDP had been the biggest party there for half a century. Never before have opposing parties controlled the two chambers—for whereas the Democratic Party of Japan (DPJ) now has the upper house, the LDP and its ally, New Komeito, have a hefty majority in the lower one.

The constitution scarcely foresaw a divided government, so the political system faces huge uncertainty. The government of Yasuo Fukuda has seen its popularity rise since he took over last month from Shinzo Abe, who resigned as prime minister after a terrible year. But the government could yet fall. If it survives, it is not clear how it can pass laws. So already murky prospects for tackling urgent problems—a high national debt, an ageing society, pension obligations and defining Japan's place abroad—have got even murkier. Yet among many politicians, a palpable thrill has supplanted the usual drudgery. The ambitious sniff a chance for personal advancement, but also to remake their parties—and even the political structure.

Mr Fukuda's first challenge is to extend the Japanese navy's refuelling role in American-led operations in the Indian Ocean. These form part of the “war on terror”, supposedly by helping seize vessels linked to the Taliban and al-Qaeda. Japan has a pacifist constitution restricting military activities overseas. But its interpretation is disputed: the DPJ's leader, Ichiro Ozawa, has long believed, quasi-religiously, that only the United Nations can mandate military operations abroad. Mr Ozawa seized on the Indian Ocean operations as a means to topple the government.

Mr Abe said he would resign if he could not extend the operations—and then resigned anyway. Mr Fukuda quickly gave up the idea of extending the current measures, in favour of a new law to authorise the Japanese presence. Suspicions have recently grown that Japanese-supplied fuel was used by the United States in 2003 in the run-up to the war against Saddam Hussein, something America denies. It has not helped Mr Fukuda keep the support of his New Komeito allies; with Buddhist roots, the party has a pacifist bent. Still, on October 17th the cabinet approved a new bill that will now go to the Diet. To appease New Komeito, it restricts the operations to just one year, with fuel to go only towards stopping suspicious ships. In any event, no new law will be in place before the existing one expires. On November 1st the Japanese navy will be recalled. It will prove a deep international embarrassment.

Yet behind the scenes, Mr Ozawa looks in sudden trouble. His own party resents his stubborn, autocratic style. To meet criticism that mere obstruction was damaging the DPJ's image, last week Mr Ozawa offered

a vision for a new international role. The refuelling was unconstitutional, he said, but a Japanese presence in Afghanistan itself, under the International Security Assistance Force (ISAF), would be fine, since this has a UN mandate.

To some, this is a brilliant stroke, cutting the ground from under the LDP, while taking the national debate forward. But many DPJ left-wingers are suspicious of all foreign involvement, and alarmed that Mr Ozawa is prepared to put Japanese troops in harm's way—not one has been killed in the 15 years since Japan first joined peacekeeping missions. Seiji Maehara, a former party leader, says that to insist on UN backing is to give Russia and China a veto over Japanese foreign policy. Meanwhile, the DPJ's shadow defence minister, Keiichiro Asao, backpedals from Mr Ozawa's recommendations. Combat troops should perhaps not be considered, but rather specialists in disarming and reconstruction.

What happens next, Mr Asao stresses, hinges on the opinion polls. The upper house could veto Mr Fukuda's bill or just sit on it for up to 60 days—should the prime minister extend the Diet session beyond its planned closure on November 10th. Either way, Mr Fukuda must then choose whether to let the bill die, or push it into law using the government's two-thirds majority in the lower house.

That is a forceful measure, never used before, and Mr Ozawa threatens an upper-house censure. But Koichi Kato, another former LDP secretary-general, says that Mr Fukuda could survive a censure if public opinion is on his side; ironically, approval of the little-understood Indian Ocean operations has risen since Mr Abe said he would stake his job on them. When television pictures show the ships' embarrassing return, opposition to withdrawal may strengthen. Mr Fukuda may close this special session of the Diet and vote on the refuelling law when the ordinary session opens in January. Then the lower house can at least get on with the crucial deliberations over next year's budget, postponing a confrontation with the DPJ.

If the government falls sooner and a general election is called, things get interesting. Some of the grizzled eminences who engineered Mr Fukuda's post-Abe coup—among them Mr Yamasaki, Yoshiro Mori, an LDP former prime minister, and Tsuneo Watanabe, who heads the *Yomiuri Shimbun*, Japan's biggest newspaper—have long viewed the DPJ leadership as just an errant LDP faction. Mr Ozawa was once LDP secretary-general before falling out and vowing revenge; his own secretary-general, once in the LDP, is the grandson of a late prime minister and brother of Mr Fukuda's justice minister. Some of these eminences dream they can arrange a “grand coalition” between the two parties.

Most likely, the ruling coalition will keep a much-diminished majority, and Mr Ozawa will be under pressure to resign. A way will have to be found for the two parties to co-operate. But other dynamics might also be at work. If the LDP becomes too hawkish, says Mr Kato, then New Komeito could desert it for the DPJ. In turn, modernists from the DPJ, among them Mr Maehara, might be asked to join the LDP. A more competitive two-party system, in other words, might just be the outcome. But that is to pitch hope over experience.

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Australia's election

Things are going so well

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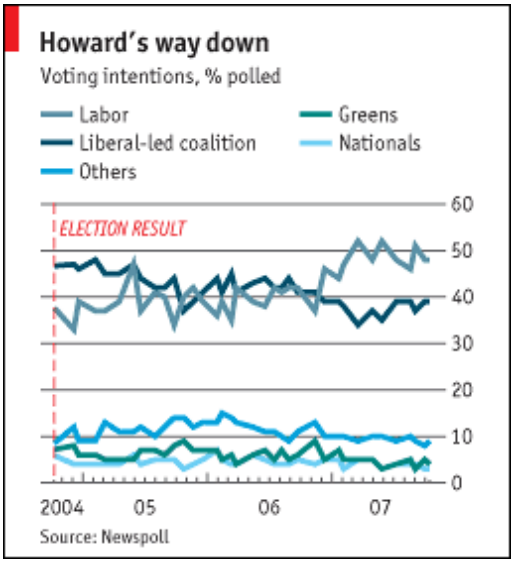
So why is John Howard so behind in the opinion polls?

Get article background

A FESTIVAL to celebrate the Granny Smith apple, born in his Sydney constituency of Bennelong, is an event John Howard, Australia's prime minister, might normally feel he could safely skip. Not this year. Mr Howard has called a general election for November 24th. After 11 years in power, dominating Australia's political scene like few before him, Mr Howard is facing the fight of his life. Opinion polls suggest his conservative coalition government could be heading for a defeat by the Labor Party. With redrawn boundaries, and a popular local Labor opponent—Maxine McKew, a former television journalist—even Bennelong could fall. This bleak spectre keeps Mr Howard grounded on his home turf more than ever.

On October 15th a poll gave Labor a 12-point lead after the distribution of second votes under Australia's preferential system. After a similar result in May, Mr Howard warned his Liberal Party that the government risked "annihilation" unless things changed. Such a poll deficit would easily give Labor the extra 16 seats it needs in the 150-seat House of Representatives to form a government.

The campaign was barely a day old before Mr Howard fired his first big shot. He promised tax cuts worth A$34 billion ($30.6 billion) over the next three years. They came on the back of figures showing the government rolling in money as Australia enters its 17th year of uninterrupted growth. Since the budget in May, the Treasury in Canberra has revised its 2007-08 growth forecast from 3.75% to 4.25%, and raised its forecast cash surplus by A$4.2 billion to A$14.8 billion. The tax cuts signalled Mr Howard's plan to fight the election on economic management, one of only two issues (with national security) on which he rates higher than Labor.



Steering the economy through a boom fuelled largely by China's demand for Australia's minerals has served Mr Howard well up to now. Written off by one pundit as "the most unlikely prime minister in modern Australian politics" when he was opposition leader 20 years ago, Mr Howard has since won four successive elections, and is the second-longest serving prime minister in the country's history. Voters in their 20s and early 30s have nothing to compare with the Howard government's 11 years of high employment, low inflation and few, if any, challenges to the social order: the "comfortable and relaxed" country Mr Howard said he wanted when he became prime minister. So some pundits are as bewildered as Mr Howard himself by his unpopularity.

His critics have no shortage of explanations. Mr Howard's tendency to use budget surpluses to throw money at voters in marginal seats shows a reckless side that has probably hurt as many voters as it has helped. In a bid to dampen a push on inflation from too much boom-time spending, the Reserve Bank has raised interest rates five times since the last election in 2004. Mr Howard won that election on a campaign promise to keep rates low, suggesting a power over the independent central bank he does not have. He can now only hope the bank does not raise rates yet again when it meets on November 6th.

The government's 2005 workplace laws, giving employers stronger power over workers, are also likely to cost it votes. Mr Howard's strong support for the war in Iraq is deeply unpopular. His conservative social policies have shifted the Liberal Party to the right and alienated many in the party's centre. Having ignored the smouldering issue of reconciliation with Australia's indigenous people, Mr Howard surprised everyone when he declared on October 11th that he would hold a referendum to recognise aborigines in Australia's constitution if he is re-elected. Cynics have questioned his timing.

Then, at 68, Mr Howard is looking and sounding his age against Labor's leader, Kevin Rudd, 50, who can be his match as a political tactician. Win or lose, this looks likely to be Mr Howard's last election. After the Liberal Party panicked in September over the bad opinion polls, Mr Howard reluctantly pledged to retire “well into” a fifth term. He has brought Peter Costello, the Treasurer (finance minister), out of the shadows to campaign with him. Mr Howard has a strong sense of his own legacy. Handing over to this younger heir-apparent would hurt. But the alternative ending is too awful for him to contemplate.

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The Pacific Islands Forum

Lepers change their spots

Oct 18th 2007 | CANBERRA
From The Economist print edition

As usual, it's Australia and New Zealand v the rest

Get article background

WHEN Fiji's coup leader, Commodore Frank Bainimarama, made it known he would attend a meeting of Pacific leaders in Tonga this week, New Zealand's prime minister, Helen Clark, said he would be “treated like a leper”. Both she and Australia's foreign minister, Alexander Downer, said they would avoid any bilateral meetings with Fiji's military commander. But not for the first time, the region's heavyweights, Australia and New Zealand, seemed out on a limb.

At the Pacific Islands Forum the commodore was welcomed warmly by Tonga's prime minister, Fred Sevele, feted rapturously by 900 rain-drenched schoolgirls and invited to dine with Don McKinnon, the Commonwealth's secretary-general. Miss Clark was cross: “I would have thought that suspension from the councils of the Commonwealth included suspension from the dinner parties.”

Opening the forum, Papua New Guinea's prime minister, Sir Michael Somare, called on Australia and New Zealand to show greater “respect for the sovereignty” of their small island neighbours. This echoed his complaints about Australian bullying at last year's forum in Fiji. Then, the targets of Australian displeasure were PNG and the Solomon Islands.

Relations have since soured further. In the midst of PNG's elections in August, Mr Downer called for Sir Michael to be charged with assisting the escape from PNG of Julian Moti, a fugitive lawyer. Mr Moti is wanted in Australia for alleged sexual offences in Vanuatu a decade ago. Australian requests for his extradition have been rebuffed. Mr Moti is now the Solomon Islands' attorney-general.

In response to allegations of Australian heavy-handedness, the forum nations agreed last year to an independent review of its peacekeeping Regional Assistance Mission to Solomon Islands, RAMSI. The leaders were to consider this in Tonga. But Mannaseh Sogavare, the Solomon Islands' prime minister, dislikes the report and boycotted the forum. His foreign minister, Patteson Oti, this month protested before the United Nations General Assembly about Australia's “occupation” of his country. The Solomon Islands government, he said, wants a clear “exit strategy” and to reclaim “sovereignty”. Having pumped nearly A$100m ($88m) into the Solomon Islands since the mission began in 2003, diplomats in Canberra are understandably anxious about RAMSI's future.

Repeated showdowns at these meetings also cast doubt on the viability of the forum itself. Formed in 1971, it joins Australia, New Zealand and 14 independent or self-governing island nations. Yet the larger nations in the south-west Pacific—PNG, the Solomon Islands, Vanuatu and Fiji—have of late strengthened

their own links through the Melanesian Spearhead Group, which has established a new Chinese-financed headquarters in Port Vila, Vanuatu. In the northern Pacific, tiny Micronesian states care more about their ties to America or Japan than those to their poor southern neighbours. The islands in the central and eastern Pacific, argues Ron Crocombe, a regional analyst, may have to revive plans for a Polynesian federation. It will take some dextrous diplomacy to keep all these far-flung island states together under antipodean leadership.

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Myanmar diplomacy

Sticks and carrots

Oct 18th 2007 | SINGAPORE
From The Economist print edition

The pressure rises—but not far enough

Get article background

THE United Nations' special envoy to Myanmar, Ibrahim Gambari, toured Asia this week to plead with the country's neighbours to step up the pressure on its military regime. As he did so, the European Union tightened its economic sanctions, banning imports of Burmese timber, gemstones and precious metals. President George Bush talked of further measures on top of those he imposed after last month's brutal crackdown on monk-led pro-democracy protests. Japan cut its aid to Myanmar in protest at the shooting of a Japanese journalist during the violence.

Mr Gambari was sent on tour after last week's statement by the UN Security Council "strongly deploring" the crackdown, calling for the release of political prisoners and urging Myanmar's regime to start a real dialogue with Aung San Suu Kyi, the detained pro-democracy leader. Unlike a council resolution, the statement was not binding and, at China's insistence, contained no threat of sanctions. But that the council reached consensus on a fairly strong rebuke was a notable achievement.

However, the regime continues to defy world opinion. It has made some token concessions: earlier this month, it appointed an intermediary to handle talks with Miss Suu Kyi. But this week it rejected the UN's statement and insisted it would "march on" with its supposed seven-step plan for democracy, which in reality is a plan to entrench the army in power. It continued to arrest protest leaders. The relatives of some detainees said they had been tried in secret and given long jail sentences. Last weekend state newspapers announced that Soe Win, Myanmar's prime minister, thought to be fourth in the junta's hierarchy, had died. His demise seems unlikely to change things.

The West has still not run out of sticks to wield against Myanmar—for example, European firms are only discouraged from investing there, not banned. But Britain's prime minister, Gordon Brown, has also offered a carrot, a big package of aid to be provided to the deeply impoverished land if its rulers make serious moves towards democracy. However, neither carrots nor sticks will budge the stubborn Burmese generals unless the Asian countries that are Myanmar's main trading partners and arms suppliers join in.

So far, Mr Gambari's reception in Asian capitals has been lacklustre. Malaysia ruled out even such mild sanctions as suspending Myanmar's membership of the Association of South-East Asian Nations (ASEAN). General Surayud Chulanont, the prime minister in Thailand's military-backed government, suggested the creation of a regional forum to solve Myanmar's crisis, comprising ASEAN, India, China and the UN, and modelled on the six-party talks on North Korea. However, the North Korean talks include countries—notably America—that urge a tough line against North Korea, as well as friendlier China. Without such a "nice cop, nasty cop" act, General Surayud's proposed forum would probably achieve little.

ASEAN's secretary-general, Ong Keng Yong, and several member countries' senior ministers this week pointed to the country's various ethnic-minority insurgencies and gave overblown warnings of "another Iraq", should the regime change suddenly. But neither the West nor Miss Suu Kyi herself is proposing a sudden regime change. Even the pro-democracy leader agrees that the army should play a strong continuing role. So far it looks as if Myanmar's neighbours are simply looking for excuses to let them return to doing business as usual with its nasty regime, as soon as all the fuss has died down.

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South Sudan

Will the war start all over again?

Oct 18th 2007 | JUBA
From The Economist print edition

AFP

Fears are rising that civil war may resume in a part of the country that has had a rare few years of peace

Get article background

"THIS time," said the south Sudanese general, jabbing at the table, "we will take the war to their children. We will fight the war in the north and they will not forget it." A few dusty streets away, in Juba, the capital of south Sudan on the banks of the Nile, an emotional crowd of supporters of the Sudan People's Liberation Movement (SPLM), which runs the south, gathered round the grave of John Garang, its charismatic leader who was killed in a helicopter crash in 2005. The protesters were listless in the midday furnace of the equatorial sun but their message was fierce and clear. If the north failed to honour the peace agreement signed in 2005, they would fight again.

That deal ended a war between north and south Sudan that had bloodily sputtered on and off for 50 years, killing some 2m Sudanese and displacing 4m more. The accord was a rare foreign-policy success for George Bush's administration. Now it may be unravelling. Does that herald a return to bloody conflict?

On October 11th the SPLM suspended its participation in the government of national unity in Khartoum. All of the SPLM's 18 ministers refused to turn up for work. Only Sudan's vice-president, Salva Kiir, who is also president of south Sudan, stayed on—but then Mr Kiir is not often in Khartoum these days.

The SPLM has many grievances, among them the initial refusal of Omar al-Bashir, Sudan's president, to let it reshuffle its ministers in the national government. It also objects to raids on its offices in Khartoum. But these slights are as nothing, says the SPLM, to the failure of Mr Bashir's ruling National Congress Party (NCP) to implement the north-south peace agreement. The southerners say they want progress before the third anniversary of the peace deal, on January 9th—or they will stay out of the national government and the peace accord may then collapse. It was unclear under what terms the SPLM would return to the government fold.

The northerners' initial response has been emollient. Mr Bashir has agreed to reshuffle the SPLM ministers and has arranged to meet Mr Kiir. But the underlying differences—over how to share power and wealth, mostly from oil—persist. The 27m or so northerners, mostly Arab and Muslim, are deeply reluctant to share power with the 8m or so southerners, who are black, Christian and animist.

If war broke out, it would probably be fought in the disputed oil fields in the borderlands between north and south: in southern Kordofan, Abyei, Unity and the Upper Nile states (see map). Rebel groups from Darfur might even join the fray.

The SPLM says there are 16,000 northern soldiers dug in, mainly around the oil wells in the border areas, together with hundreds of ill-disciplined and unauthorised “oil police” who would do the northern government's bidding. The southerners can probably muster some 70,000 former guerrillas who look a little more regular these days, in clean spats and uniforms, but they are still nearly all illiterate, ill-equipped, easily frustrated and prone to drinking and picking fights among themselves.

Under the peace agreement, northern troops should have been withdrawn in July, to be replaced by a joint command of northern and southern troops. Instead, the northerners appear to be reinforcing their positions. The mood is particularly tense in Abyei, an area the south thinks it can win over in elections due in 2009. The region's strategic importance and the NCP's need to be seen by its supporters (most of them Muslim Arab northerners) to stop what they see as the erosion of their country make it unlikely that Mr Bashir will be willing to carry out what he agreed to in 2005. Southern enthusiasm for the deal only raises suspicions in the north that Mr Bashir signed too much away.

A lot of oil is at stake. Some talk of 6m barrels a day in the future, albeit much of it low-grade. There are plans for pipelines westwards through Congo to the Atlantic and south-east through Kenya to the Indian Ocean, as well as a South African-planned railway to run south into Uganda to connect with east Africa's network. But most business-minded observers think such plans fanciful, like the models of Juba skyscrapers in government offices.

What is less fanciful is the southerners' determination. Just as the north thinks it has good reason to hold the line, the south is loth to let the 2005 agreement go. For ordinary southerners it is talismanic, even sacred; having cost 2m dead, it cannot be dishonoured. Most southerners look eagerly towards a referendum on independence in 2011, as agreed in the peace accord. Rough opinion polls suggest that they would vote overwhelmingly to secede. Sticking to the accord is seen as the last hope for north and south Sudan either to come to a federal accommodation or to go their separate ways—in peace.

A miscalculation by either side in the coming weeks could set the south ablaze, not least because the UN, which has 10,000 peacekeepers there, is absent from the hotly contested areas and is unlikely to be deployed in them any time soon. “The fuel is on the ground,” says an experienced Sudan watcher. “It just needs a match.”

No one knows what to do

Set against the spectre of war is the reality of peace. The south has been safer than in decades. Bellicose words are often followed by calmer ones. “We know what war is,” says Pagan Amum, an SPLM leader. “We have waged it, we know its cost to our people.” He wants foreign governments, this time including China's, to make Mr Bashir try harder to secure peace. The SPLM is annoyed that America has failed to force the issue already.

Seen from Juba, muddle and frustration prevail. America and others are distracted by Darfur, whose protagonists are to meet in Libya later this month to talk peace. In south Sudan, foreign donors cannot decide if they are dealing with a humanitarian emergency or building a nation. Ministry buildings are going up, but many of Juba's people live in tents.

Life for ordinary southerners is still grim. One woman in eight dies giving birth, the world's highest rate. Poverty is grinding, infrastructure rotten. The lifeline road to Uganda is unpaved; prices shoot up when it gets mired after rain. Swathes of the south are inaccessible. Though there is hopeful talk of gold, uranium and cadmium (used in batteries), it is hard to see how an independent south would survive—even if it broke peacefully away. But that will not stop its people from trying.

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Africa and the internet

The digital gap

Oct 18th 2007 | NAIROBI
From The Economist print edition

More than a click to put Africa online

WHEN it comes to computing power, the gap between Africa and the broadband world is still a Grand Canyon. Only 4% of Africans have access to the internet. They pay the most in the world, around $250-300 a month, for the slowest connection speeds. E-commerce barely exists. Nigeria's 140m-odd people have but a few hundred decently trafficked websites in their domain. Blogging is a vibrant but peripheral activity.

If sub-Saharan Africa were scaled according to its available internet connectivity, it would be about the size of Ireland. Of its 48 countries, the 28 in central and eastern Africa are connected to the web by only the flimsiest of satellite technology. Apart from the occasional internet hook-up at a diamond mine or UN camp, whole regions of Congo and Sudan, sub-Saharan Africa's two largest countries, have no connection at all. Even countries like Uganda, which are go-ahead about the internet, start from a very low base. Research by Microsoft found only one in 200 Ugandans regularly uses e-mail.

The number is higher in west Africa, where the more robust SAT-3 undersea cable provides for higher speeds and lower costs. The Eastern Africa Submarine Cable System, better known as EASSY, which runs 9,900km (6,152 miles) along the Indian Ocean floor from South Africa to Sudan, is meant to speed up connections in east and central Africa in the next few years but is not yet operating.

African users must also cope with obsolete systems, irregular electricity and a stultifying lack of local content. Interfaces are being written in a number of African languages, but even the clearest instructions in Wolof or Yoruba as to how to use Windows presume a fair degree of literacy. Then there is the high graphical content of the rich world's web: videos and social networking are unworkable in the snail-slow dial-up offered in most African internet cafés.

All of this would be worse for Africans if state telecom monopolies had kept their grip. But fortunately they have been cast aside by leaner and more transparent mobile-phone companies, which the World Bank says may have poured $25 billion into Africa in the past ten years. The continent remains an enormous investment prospect, not least in internet offerings.

A UN call in 2005 for “digital solidarity” has so far amounted to little. A big conference called Africa Connect, to be held in Rwanda later this month, is meant to give a boost. It says it will be “pure business”, not charity. African governments will face pressure, from the World Bank and the African Development Bank among others, to slash red tape and encourage technology firms in the hope of cutting the cost of going online by two-thirds and getting ministries, hospitals and schools onto the internet by 2012.

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Nigeria

A nation in waiting

Oct 18th 2007 | ABUJA
From The Economist print edition

The people are watching the new president to see which way he will go

DESPITE the stench of April's elections, described by many observers as the most fraudulent they had ever witnessed, the new president, Umaru Yar'Adua, has been enjoying a honeymoon with the Nigerian electorate. For a country that has known little but corrupt military or civilian rule in the past 40 years or more, Mr Yar'Adua at least looks and sounds different. But now Nigerians are waiting for him to take the harder decisions that alone may sort out some of their country's more intractable problems. Only then will they be able to tell if he is truly up to the job.

The "servant leader", as he styles himself, has made a fair start, even if it amounts so far mainly to promises and gestures. Mr Yar'Adua has announced several plans to boost Nigeria's economy, root out corruption, get the power-grid working again and stem the rising violence in the Niger Delta region and elsewhere. He has avoided meddling in a corruption scandal in the National Assembly, as his predecessors might have done, leaving the legislature's committees to sort it out. And, just as significantly, he has refused to intervene on behalf of former state governors from his own party who have been indicted by the country's anti-corruption agency. The tribunals set up to challenge the election results have also been allowed to operate freely; on October 10th, one called for fresh elections in Kogi state.

AP

How much time does he have?

The economy is in better shape too. It is growing at about 6% a year, while inflation is down to single figures, about four times less than the rate in 2000. Better fiscal management has meant more foreign currency in the banks and more foreign investment. Nigeria is now the 32nd most corrupt nation in the world, according to a Berlin-based anti-corruption watchdog, Transparency International, down from the top spot in 2000: progress of sorts.

Yet Nigerians know that enormous problems persist; their patience may soon run out. In the Niger Delta, the biggest militant group, the Movement for the Emancipation of the Niger Delta, declared a ceasefire for a few months after Mr Yar'Adua took office. But last month it returned to its customary kidnappings and sabotage. Moreover, the violence has got nastier and more indiscriminate. The kidnappers have begun to nab children, as well as foreign oil workers, politicians and ordinary Nigerians. To flush the militants out of the creeks, the new vice-president, Jonathan Goodluck, a local man, has begun meeting representatives of the various Delta groups. But peace still seems a long way off.

The increasing violence stretches far beyond the Delta. A report by Human Rights Watch, a New York-based lobby group, details how political parties armed rival gangs to rig elections and intimidate voters in 2003 and again this year. Many of the politicians have failed to cough up for those services, so the gangs have been venting their frustration on the streets.

Despite being Africa's largest oil producer, Nigeria still fails to provide enough power for its own people. Electricity is sporadic in towns and almost non-existent in the countryside. A closet industry of private generators fills the gap at a price sometimes ten times that of state-generated power. The president created a National Energy Council last month and told it to come up with a plan to solve the power crisis in six months. But he himself seems to have few firm ideas how to do it.

One constraint on Mr Yar'Adua is that most of the revenue from Nigeria's oil goes to the 36 states, which are then meant to provide the desperate people with their local services. These local governments are often the most corrupt. So the president will have to find a way of ensuring that the huge sums of money available actually reach the people—for instance, in the Delta. To do that, he will have to free himself of

the political networks and alliances that he inherited from previous administrations and which still ensnare the country. Nigerians are waiting to see which way he will move.

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Syria

A mystery unsolved

Oct 18th 2007 | DAMASCUS
From The Economist print edition

What the Syrians say about a recent Israeli air raid

Get article background

EIGHTEEN days after a mysterious Israeli air raid on a Syrian target that neither country has so far identified, near the town of Deir ez-Zor in the north-eastern desert on the Euphrates river, an air-raid siren wailed in Damascus, the capital. Barely anyone looked up. Syrians are used to being on a war footing with their neighbour and the sirens are regularly tested. While the Western media speculated excitedly over exactly what was hit and why, most Syrians accept the official version of events—or at least accept that it may be a while before they know the full story.

Rumours and theories still swirl. Missiles on their way to Hizbullah, the Shia movement that Syria backs in Lebanon? A nuclear reactor in the early stages of construction? Were North Korean nuclear technicians involved? A full three weeks after the attack, President Bashar Assad gave a supposedly definitive account to the BBC: “They bombed buildings and constructions [sic] related to the military, but it's not used, it's under construction, so there are no people in it, there is no army.” Only the next day did Israel confirm that it had, indeed, hit a military installation. Syria's foreign minister confusingly said the place was agricultural, not military.

AFP

Assad says it was harmless, whatever

Initially cautious, the government in Damascus sought to manage the news. The official media huffed and puffed, describing the raid as “wild” and “a new act of piracy”, then dropped the topic from the headlines. When an Israeli journalist on a foreign passport visited the area and published a snapshot of himself posing outside the supposed target, Syrian commentators showed less interest in the target and more outrage at how the reporter had slipped in unnoticed. The authorities then organised a rural outing for foreign journalists to an agricultural set-up near Deir ez-Zor, who duly reported the baffled denials from Syrian crop scientists who said they had neither seen nor heard a thing.

If Syrians do not appear to be driven to discover the details of the attack, it may be that they think they know the motive. “It's Bush, pushing us into a provocation with Israel,” was a typical comment. “But I don't think there's going to be any war.”

Syria's government has lodged a formal complaint with the UN. It has consulted its neighbours and encouraged Turkey to mediate. The state news agency said that Mr Assad's visit this week to Ankara, Turkey's capital, had gained importance thanks to the recent raid. The Turks were the first to protest against it because the Israelis had encroached on their air space and had dropped empty fuel tanks on Turkish soil on their way home.

Elsewhere in the region, many Arab analysts joined in the speculation. Was the raid an indirect way for Israel and its American ally to warn the Iranians of what may happen if they continue to enrich uranium? Or was it just an Israeli exercise to test Syria's air-defence system, said to have been upgraded by the Russians? Most Arab commentators, however, suggest that the raid was meant to stir bad blood between the two old enemies and ensure that Syria would refuse to attend the Israel-Palestinian peace conference expected to be held in America next month.

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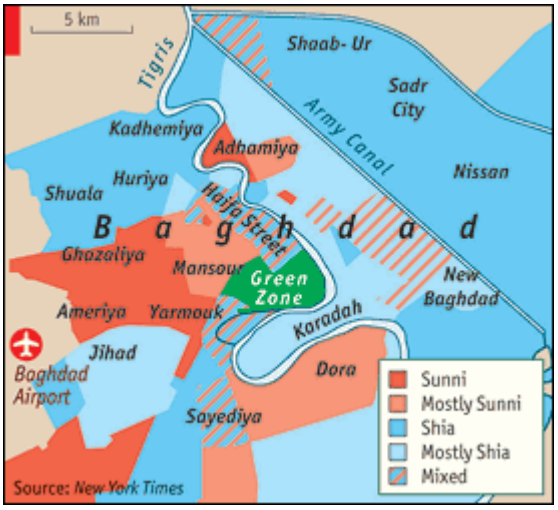
Iraq

A rare moment of calm in the capital

Oct 18th 2007 | GHAZALIYA, BAGHDAD
From The Economist print edition

The American military surge is working in parts of Baghdad. But for how long?



BACK in February, units of the American army were bogged down in an apparently unwinnable battle against al-Qaeda in the west Baghdad suburb of Ghazaliya. The insurgents treated this once mainly Sunni Arab area as a safe haven which they fiercely defended. American troops were attacked virtually every time they sallied from their base, whether by snipers or by booby traps consisting of piles of explosive stuffed into sewers. Human intelligence—the tips that the Americans need for tracking down insurgent cells and arms caches—was almost nil, no doubt partly thanks to the intimidation caused by the two dozen or so bodies of suspected collaborators, often beheaded or bearing marks of torture, that were dumped every month on Ghazaliya's outskirts.

Eight months later, the picture is quite different. The district has been transformed. American troops move freely through it, dropping into schools and stopping off at markets to chat with locals or to check up on a new citizens' militia, the Ghazaliya Guards, who man checkpoints throughout the suburb. In the part of the suburb revisited by this correspondent, the insurgents have apparently not managed to launch an attack for the past two months.

It took six months of hard fighting, say the Americans. The breakthrough followed the setting up of local “combat outposts”—small bases inside the neighbourhoods—which let American soldiers become permanent fixtures in the battle for local loyalties rather than itinerants who come and go. Extra Iraqi troops have helped. So, crucially, have the high concrete walls that now surround Ghazaliya.

This strategy has been promoted by the American commander in Iraq, General David Petraeus, who says that deploying American troops in force deep inside Baghdad's districts can help win back ground. The strategy was pioneered in the province of Anbar, west of Baghdad, and has only recently been applied to Baghdad's own suburbs. So an “oil spot” of stability, to use an American buzzword, seems to have spread from western Iraq into the capital's outskirts, thanks both to increased troop numbers and to a Sunni backlash against al-Qaeda. The tribal militias of Anbar and the Ghazaliya Guards, both mainly Sunni, have evidently turned against al-Qaeda, though most of its fighters in Iraq are now home-grown.

But Ghazaliya is far from happy. Locals complain about the lack of public services, the hassles caused by the protective walls and abuse by the police, who are mainly Shia. Many of Ghazaliya's residents are Sunni refugees from formerly mixed districts of Baghdad who have fled from Shia militias and are afraid to go back home. Moreover, even now, at

Reuters

the height of the surge, the American army has too few troops to pacify all the suburbs of Baghdad, let alone areas beyond the capital.

The Americans hope that growing numbers of Iraqi troops as well as groups of “concerned citizens”, such as the Ghazaliya Guards, can start bearing a heavier burden. Ramadi, a provincial capital to the west of Baghdad that was once Iraq's most violent spot, is now often cited by American optimists as a tranquil town where the Iraqi police—not the Iraqi or American army—is the main presence on the streets.

But can it last or spread? It is still uncertain whether Ghazaliya's new calm marks an inexorable advance towards stability in Baghdad, let alone farther afield, or is just a blip in a cycle of sectarian bloodshed that will resume with a vengeance once the surge is over, maybe in the spring.

Sweetness and light

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Iraq and Uganda

The war is good for some

Oct 18th 2007 | KAMPALA
From The Economist print edition

Ugandans join the ranks of private security firms in Iraq

WHILE Americans and Iraqis argue over the merits and defects of private security companies in Iraq, for David Golola, a former private in the Ugandan army, Iraq's war means seed money for his mango-juice business. For he is one of 3,000-odd Ugandans who have been working in Iraq as security guards on American military bases, thanks to a contract with EOD Technology, a Tennessee-based firm that specialises in dealing with unexploded bombs and provides general security services to the Pentagon.

Like the other Ugandans who have been in Iraq, mostly former soldiers and policemen, Mr Golola considers himself lucky. Many have used their salaries of around $1,000 a month, about ten times that of a private in the Ugandan army, for starting businesses and buying property. One began a maize-grinding plant; another now has his own soap factory.

Not everyone, however, is keen to pack off thousands of Ugandans to guard American soldiers in a dangerous and distant desert. President Yoweri Museveni, the only leader among the 53 countries of the African Union to send peacekeepers to Somalia as well as Darfur, has been criticised by some Ugandans for putting his soldiers in harm's way to curry favour with the Americans in their proclaimed fight against global terror. To make matters worse, a scandal involving alleged underpayment and bad treatment of the security guards has dogged several of the Ugandan firms (one of them close to the president) that have been chosen by the government to recruit the men.

All the same, thousands of eager Ugandan men have put themselves on the waiting list to join the firms. “Even though it's a war zone,” explains a guard back home on leave, with plans to start a dairy, “Iraq is a better option than Uganda.” None, so far, has been killed.

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Correction: Nigeria's oil

Oct 18th 2007
From The Economist print edition

In an article on reforming Nigeria's oil industry (September 29th), we said that the country's production had sunk to just 750,000 barrels a day, owing to violence in the Delta region. What we meant to say is that oil production had fallen by 750,000 b/d, well below Nigeria's capacity of 3m b/d, but not nearly as catastrophic. Sorry.

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Russia's foreign policy

Last tango in Tehran

Oct 18th 2007 | MOSCOW
From The Economist print edition

EPA

An assertive Russia is choosing to pursue its own foreign-policy goals, and they differ from the West's

Get article background

VLADIMIR PUTIN is an erudite man. During a meeting with Germany's Angela Merkel in Wiesbaden on October 15th, he noted that this was the spa town where Dostoyevsky played and lost at roulette. Yet in Tehran the next day, he kept his knowledge of 19th-century literature quiet, choosing not to mention a Russian poet and diplomat, Alexander Griboyedov, who was killed in Tehran when the Russian embassy was destroyed by a mob.

Russia's deep-rooted apprehension about Iran echoed in the news spread by its security services on the eve of Mr Putin's visit that Islamic fanatics were plotting to kill the Russian president. This added spice to Mr Putin's attendance at a summit of Caspian countries. (The last Russian leader to come to Tehran was Stalin in 1943, for a summit meeting with Churchill and Roosevelt.)

On the face of it, Mr Putin gets on with Mahmoud Ahmadinejad; he even invited the Iranian president to Moscow. Talking to a Russian news agency, Mr Ahmadinejad insisted that Russia and Iran were natural allies. As for Mr Putin, he noted that “Russia is the only country that has assisted Iran in implementing its peaceful nuclear programme.” And, in a dig at the West, he said “we should not even be thinking of making use of force in the region”, and that no Caspian country should allow its territory to be used by a third country as a military base against another.

This chumminess may seem just another example of Russia's anti-Western foreign policy, especially as it came soon after a frosty meeting with Condoleezza Rice and Robert Gates, respectively America's secretaries of state and defence. Mr Putin kept the two waiting for more than half an hour, and then poured scorn on America's planned missile-defence system in Poland and the Czech Republic. He also repeated Russia's threats to pull out of the INF treaty to eliminate intermediate-range nuclear missiles, unless its curbs are extended to other countries.

Certainly Russia's foreign policy has not been helpful to America. But it was never meant to be. Russia only reluctantly signed up to two United Nations sanctions resolutions against Iran, and it has so far refused to back a third. Mr Putin claims that there is no evidence that Iran is pursuing nuclear weapons, and argues that further sanctions will do no good to anyone. Less helpful to the West has been the sale of Russian anti-aircraft missiles to Iran.

As far as Mr Putin is concerned, Russia has its own interests, which differ from America's. Russia is worried about Iran becoming a nuclear power: Iran is far nearer Moscow than Washington, and a nuclear

power to the south is the last thing Russia wants. Nor does Mr Putin take lightly Iran's threat to wipe out Israel. He told a European Jewish Congress in Moscow that Russia and Israel were the two countries most threatened by a nuclear Iran. This week Israel's prime minister, Ehud Olmert, flew to Moscow to discuss Mr Putin's ideas for breaking the deadlock over Iran's nuclear ambitions, as well as the Palestinian peace process.

Yet Russia has no wish to alienate Iran, either. Iran has kept out of Russia's military conflict in Chechnya and has not intervened in either the Caucasus or Central Asia. Russia wants to keep it that way, and also to protect its own commercial interests in Iran. On this basis, to be seen to back even a hypothetical attack on Iran by the Americans would be suicidal. Which is not to say that Russia would side with Iran in any military conflict. “An American pilot hit by a Russian-made rocket would not be in Russia's interest,” comments Dmitri Trenin, deputy director of the Carnegie Centre in Moscow.

This is also why, for all his apparent friendliness, Mr Putin trod carefully in Tehran. He went out of his way to explain that his visit was planned five years ago as part of a five-country summit, not a bilateral trip. He did not pledge Russian support for Iran in case of a military attack, and he refused to set a date for the delivery of the nuclear fuel for the Bushehr nuclear reactor complex that Russia has helped Iran complete. “I only gave promises to my mother when I was a little boy,” Mr Putin sneered in answer to an Iranian journalist.

Mr Putin's visit to Tehran is an example of the sort of independent foreign policy that the Kremlin favours these days. When Mr Putin telephoned George Bush immediately after the September 11th, 2001 attacks he made the choice to ally Russia's interests with those of America. That alliance no longer holds. Russia may not be with Iran, but it is not with America and Europe either. It continues to oppose missile defences in Poland and the Czech Republic (see article), not because they threaten Russia's own nuclear capacity, but because they do not sit with the Kremlin's world view. “What Russia craves is respect. It does not want to be a junior partner—it wants to be an equal,” says Mr Trenin. That makes Russia less ready than it once was to cede to Western pressures.

Russia is, of course, entitled to pursue its own interests. What is less clear is whether it will serve these in the longer term by distancing itself from the West. An aggressive energy policy in Europe has backfired as the Europeans look for ways to protect themselves from Gazprom, Russia's state-owned gas giant. Mr Putin's independent foreign policy thus carries its own risks. He can only hope to be luckier than the famous 19th century Russian novelist was in Germany.

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Italian politics

The candidate of compromise

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The mayor of Rome becomes the centre-left's heir-apparent

ASKED once about his religious convictions, Walter Veltroni is said to have replied: “I believe that I don't believe”. The 52-year-old mayor of Rome has many qualities, but stubborn commitment is not among them. On October 14th he won a huge majority in the primary for the leadership of Italy's new Democratic Party. A convention will soon formalise the merger of the ex-communist Left Democrats with Democracy and Freedom (Margherita), made up mainly of former Christian Democrats, to form the new party. Between them, the two groups took 30% of the vote in the April 2006 general election. Anyone willing to pay a euro could take part in the primaries and, the organisers say, 3.5m Italians did. Mr Veltroni won 76% of the vote; his closest rival won 13%.

Neither party put up a heavyweight rival, a recognition that Mr Veltroni is well-suited to the job. A professed admirer of America's Democratic Party, and particularly of John Kennedy, he was the first centre-left leader to press for a broader movement in the 1990s. He has since stayed on the right-most tip of the Left Democrats. His election now makes him heir-apparent to the prime minister, Romano Prodi, and the centre-left's most likely leader at the next election. He has proven electoral appeal. In 2006, when he ran for a second term as Rome's mayor, he boosted his vote from 53% to 61%. His is also an unusually young face in a country of ageing leaders. He favours forward-looking rhetoric: his campaign promised a “new season” and at his victory press conference he promised that the Democratic Party would be a “new force” with a “new language”.

Perhaps. But it is also heir to movements that have been around since the birth of the republic in the 1940s. Mr Veltroni has been at the heart of Italy's political machinery for over 30 years (he was elected a Communist councillor in Rome at the age of 21). He later joined the national parliament and first entered government (as deputy prime minister in Mr Prodi's first government) at 40. For four years, he edited the official newspaper of the Communists' successor party. The experience gave him media antennae as sensitive as any Italian politician's. His whole life has been tied up with the media and arts. An avid movie fan, his most eye-catching achievement as Rome's mayor was to launch the city's film festival. He has written over a dozen books, including a novel. He is knowledgeable about jazz. A film based on his life of a Sicilian pianist was showing in cinemas this week.

The commonest criticism of Mr Veltroni's performance in Rome is that he sacrifices content for image. Gianni Alemanno, the contender he crushed last year, says that “he has not resolved any of the true, fundamental problems of the city: transport, urban planning, housing, even waste disposal.” His admirers dispute this. But few would disagree that Mr Veltroni's leadership has been characterised by conciliation, compromise and old-fashioned Italian deal-cutting.

A competition authority investigation that ended in July highlighted how the Rome council under Mr Veltroni fixed a tender offer for a big public-transport contract to eliminate competition. The only bidder was the existing franchise-holder. When the central government urged local authorities to liberalise taxi licences and Rome's cab drivers staged illegal and violent protests, Mr Veltroni handled them with kid gloves. He has raised the number of licences, but not by much.

For the formidable task of pulling together Italy's heterogeneous centre-left, Walter Veltroni is an excellent choice. But what his country really needs in its next prime minister is somebody bold enough to open its fusty economy to greater competition. Little in Mr Veltroni's record suggests that he is the man for that job.

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Missile defence in Europe

Sky high

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America needs to sell its plans more persuasively

MINDFUL of American help in the cold war, the Czech Republic and, especially, Poland are among the more Atlanticist countries in Europe. Yet the administration's plans to base ten interceptor rockets in Poland and a radar base in the Czech Republic, though supported by both countries' governments, have gone down badly with voters.

The risks seem high (Russia talks of measures to “neutralise” the installations) and the rewards low. “It is seen as a gift to America without reciprocity,” says Radek Sikorski, a former Polish defence minister who is now a candidate for the opposition Civic Platform, the front-runner in the election on October 21st. He thinks a fairer deal would include upgraded Patriot missiles to protect Warsaw, of the type already deployed in South Korea and Japan. These, he says, would cost $1 billion, or “12 hours of the Pentagon's budget”. Yet far from offering sweeteners, America has treated its allies with arrogant disdain. The diplomatic notes requesting the bases even came with prepared replies attached.

Opposition in Poland is shallow. The two biggest parties are in favour, and the issue has barely featured in the election campaign. Poles see a good case for stronger defence ties with America. Their country borders Russia and Belarus, and—at least under the prickly leadership of the Kaczynski brothers—has had worries about Germany too.

The calmer Czechs, by contrast, find the health risks from the radar alarming. America was oddly slow to provide the technical information to rebut these fears. Worse, the government in Prague has blundered. Local officials in the region where the radar is to be based say the politicians tried to buy them off with millions of euros in subsidies. They detect an echo of communist propaganda in their rulers' declarations of loyalty to a military ally, plus an unwillingness to give straight answers. The government's representative for the radar, Tomas Klvana, once lobbied for the tobacco industry, not a good background from which to reassure people about safety. Many opponents of the radar insist they are not anti-American, and resent being depicted as leftist nutcases.

Better diplomacy could ease worries in Poland and the Czech Republic. But two questions remain. One is whether missile defences, hugely profitable to contractors, will work in reality. The other is why Russia is making such a fuss. Both geography and arithmetic support the American argument that the system is meant to counter a handful of missiles that might one day be fired from Iran, rather than the Kremlin's colossal nuclear arsenal, which can be launched from land, sea and air.

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Spain's past

A rude awakening

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The Spanish government rakes up painful past memories

FRANCISCO FRANCO, *caudillo* of Spain, must be turning in his grave. Some 32 years after his death, a Socialist government is pushing through a law to honour the dictator's victims, as well as those of the civil war that brought him to power. Final amendments to the “historical memory” law were made by a parliamentary committee on October 17th. After years of deliberations and much angry debate, the law seems likely to be approved on October 31st.

This should be a moment of great personal satisfaction for the prime minister, José Luis Rodríguez Zapatero. The new law was one of his campaign pledges in 2004. His own grandfather, a captain in the Spanish army, was a civil-war victim. He stayed loyal to the Republican government after the 1936 military rebellion and, like thousands of other loyalists captured over the next three years, was shot.

The historical memory law is expressly directed at the victims' descendants. The draft mixes grand symbolic gestures with smaller, concrete measures. On the symbolic front, it repeals some moribund Francoist laws; it also orders the removal of the few remaining symbols of Francoism from public buildings. On the concrete side, it opens up archives and provides for the exhumation of those tossed into anonymous graves by Francoist death squads.

The most surprising thing about the law is not its content but its timing. Franco died in 1975. The civil war, when the worst events took place, ended 68 years ago. Spain is not unique in having a nasty authoritarian past—several central European and Latin American countries have faced the same issues. But many even of those that became democracies later than Spain acted on their history long ago. Among the measures they have used are truth commissions, purges, the opening of archives and trials.

Spain's uniqueness stems from its conscious decision to turn its back on the past. An unwritten agreement known as the “pact of forgetting” helped to smooth the rapid transition to democracy after Franco's death. An amnesty ensured that none of his officials was prosecuted. Only a few somewhat tepid measures were taken to deal with the legacy of the past.

The new law shatters the pact of forgetting. This may explain why Mr Zapatero's government has struggled for so long to come up with a text. The opposition People's Party, which he will face at a general election next spring, accuses him of violating the spirit of the democratic transition and awakening the ghosts of Spain's bloody past. What, it asks, about the victims on the other side in the civil war?

Spain's bishops are just as angry. They will gather at the Vatican later this month to beatify 498 victims, mostly priests, monks and nuns, of leftist Republicans during and before the civil war. “Reconciliation seems under threat,” intoned the bishops, as the historical memory debate heated up. The draft law tries to head off accusations that it is one-sided by adding those persecuted for religious reasons to its list of victims. Yet even some on the left are unsettled by such tinkering with the past. “Francoism deprived victims of their lives or freedom, but never of their dignity,” the normally pro-government *El País* commented. “It is difficult to restore dignity to those who never lost it.”

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French strikes

Sarkozy's bad week

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A tale of strikes and falling popularity

EMPTY railway platforms, deserted bus stops, paralysed roads: France ground to a halt on October 18th, as transport, electricity and gas unions led a one-day strike against a planned reform of the “special regimes” for public-sector pensions. For the first time since 1995, all eight of the main railway unions joined the strike, as did some teachers and many others. Perhaps the only really happy commuters in Paris were those who had managed to grab early one of the capital's 10,600 popular Velib' rent-a-bikes.

There are two ways to interpret this week's show of union force. One is that it is the first sign of a return to 1995, when four weeks of strikes against a similar pension reform forced the government of the day to abandon its plans altogether. Union leaders are to meet early next week to decide whether to call a follow-up strike. For Bernard Thibault, leader of the communist-backed Confédération Générale du Travail, the biggest rail union, who cut his teeth as a railway-union boss in 1995, this is his chance to flex his muscles at President Nicolas Sarkozy, not only over the pension regime but ahead of a raft of other reforms this autumn.

Yet a more plausible reading is that this is the last gasp of a union movement that faces a changed political outlook in France. From January 2008, the law will require a minimum service on public transport during strikes. Reform of the special regimes, which cover 500,000 workers and 1.1m pensioners, has hardly come out of the blue. The centre-right Mr Sarkozy was elected on a campaign promise to do away with the regimes, which let railway, electricity and gas workers retire as young as 50 on full pensions, when the rest of the public sector has to work until 60.

Perhaps most important, public opinion has changed. At various points in 1995, 54-62% of French voters backed the strikers. Today fully 55% say that the one-day strike is “not justified”, according to a poll in *Le Figaro*. The same poll reported 59% as saying that the unions were defending their vested interests, not protecting social benefits in general. The public has thus shifted against the strikers, and now sees their pension perks as unfair. Such a switch should give Mr Sarkozy the popular support he needs to stick to his guns.

In some ways, Mr Sarkozy needs a show-down with the unions. Although this week's strike is far from what might be termed his “Thatcher moment”, it does give the president a chance to show that he will not be bullied by the French street in the way of so many of his predecessors. It also comes at a particularly difficult time for the hyperactive Mr Sarkozy.

His stellar popularity has begun to ebb. His deputies are grumbling that he gives too many jobs to the left. His plan to introduce DNA tests for immigrants has run into trouble with some of his own ministers. And for the past two weeks, the media have been on a feeding frenzy over his marriage (he is now separating from his wife, Cécilia). This week's strike is the first big test of Mr Sarkozy's resolve since he was elected five months ago. In the past, he has preferred to cut deals rather than face down an adversary. The public would welcome a firmer stance this time.

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Serbia's future

The Russian option

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Some Serbs dream of a Russian alternative to the European Union

DOTTED across the Serbian north of the divided city of Mitrovica are pictures of its hero: Vladimir Putin. Russia, Kosovo's Serbs believe, has saved them from the independence demanded by its Albanians (Kosovars), who make up 90% of Kosovo's 2m people. It is too early to be sure they are right. But Western diplomats are worried by Serbia's dalliance with Russia.

Marko Jaksic, a member of Serbia's Kosovo negotiating team, helps to run northern Kosovo. He is a deputy leader of the party of Vojislav Kostunica, Serbia's prime minister. If America and many European Union countries recognise a unilateral declaration of independence by Kosovo, he expects Serbia to offer Russia military bases “in Serbia, and especially on the border of Kosovo”. He adds that Serbia should abandon its bid to join the EU, and claims that Mr Kostunica thinks similarly but has less freedom to talk openly.

Such talk is meant to send chills down Western spines. If Serbia gave up trying to join the EU, not only would it return to the isolation of the 1990s but it could also drag the whole region down with it. How serious is the risk? Mr Kostunica's party is aligned with Mr Putin's United Russia party, and its official position is that Serbia should be neutral. Mr Kostunica has disparaged a potentially independent Kosovo as nothing but a “NATO state”.

A source close to President Boris Tadic, whose party is in uneasy coalition with Mr Kostunica, concedes that, if Kosovo's independence is recognised, it will be hard to instil “European values” in Serbia. Even Serbs who would secretly like to be shot of their troublesome southern province fear that full independence would be disastrous. They predict that Mr Kostunica would, if not formally end the country's bid for EU membership, at least slow it down, as well as trying to punish countries that recognise Kosovo and companies that trade there and in Serbia.

Yet the Russian alternative does not look appetising. The prospect of Russian bases in Serbia is “very unlikely”, says Ivan Vejvoda, who heads the Balkan Trust for Democracy, a big regional donor to good causes. Serbia is surrounded by the EU and NATO. “The Russian thing is a temporary, opportunistic thing, a balloon which will burst once we are over Kosovo,” he says. There is much excitement in Serbia about Russian companies moving in. On the list for privatisations that may interest them are JAT Serbian airlines, Belgrade airport, a mine in Bor and NIS, Serbia's oil company. Alexei Miller, head of Russia's energy giant, Gazprom, met Serbian leaders to discuss potential pipelines on October 9th. But so far Russian companies (except for Lukoil) have been notable by their absence. Russia is only the 18th-biggest

investor in Serbia; the country's largest single exporter is owned by US Steel. The EU has poured lots of money into rebuilding Serbia. If Serbia kept on track, a lot more cash could come—and Russia offers little.

On October 15th Montenegro signed a “stabilisation and association agreement” with the EU, normally a step towards membership. Serbia could soon do the same. But a negative report to the EU from Carla Del Ponte, chief prosecutor at The Hague war-crimes tribunal, means that it must first be seen to do more to catch the fugitive Ratko Mladic. Ms Del Ponte will visit Serbia soon to check progress (the government has posted a reward for the missing general, 12 years after he was indicted). This suggests that the Russian option is, as one diplomat puts it, “loose talk”—for now. If many EU countries recognise an independent Kosovo next year, it will be their turn to call Serbia's bluff.

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Kosovo's future

Fretting

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Independence is not quite in the bag

KOSOVO should be abuzz. A general election is due on November 17th. Soon afterwards Kosovo's Albanians (Kosovars) hope to declare independence, becoming the seventh country to emerge from the wreckage of Yugoslavia. Yet gloom hangs over the province, under United Nations jurisdiction since the end of the war in 1999. Too many promises have been broken for the Kosovars, who account for 90% of Kosovo's 2m population, to buzz.

The election will change little. None of the parties has any policies beyond independence. They are based on personalities and quarrels over who did what in the war. It will be, sighs a source close to government, “only a reshuffling of the pack”. There is a wild card, in the shape of Behgjet Pacolli. This Kosovar tycoon made his fortune as a builder in Russia and the former Soviet Union and has plastered Kosovo with posters of the Kremlin and other buildings he worked on, stating how many Kosovars he employed on each.

A troika of ambassadors from Russia, America and the European Union is holding talks between the Kosovars and Serbia, due to end on December 10th. After that, as there is unlikely to be a deal, the Kosovars want to declare independence. But a declaration will be worthless unless many countries, especially in the EU, recognise it.

With holidays and time needed to form a government, little will happen until early next year. Then Kosovar leaders fear that there may be calls for yet another round of diplomacy. They are nervous of a repeat of the Balkan past. In 1878 Bosnia came under Austro-Hungarian rule, but with nominal sovereignty staying with the Ottomans. The Kosovars fear that, once the UN mission is replaced by an EU one, the big powers might press them to accept that, even if Kosovo begins acting as an independent state, Serbia should retain sovereignty at least for a few years.

Kosovo's leaders will not accept this. Ominously, one armed group has made a dramatic appearance on television. Albin Kurti, a former student leader under house arrest for leading a protest that turned violent, says that 2m people in Kosovo are, in effect, under house arrest. He argues against any further negotiations, since negotiations always aim at compromise—and Kosovo cannot compromise on independence.

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Charlemagne

Europe's horse whisperers

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Illustration by Peter Schrank

How politicians conjure up their own demons before summits

IN THE scientific annals there is a cautionary tale of Clever Hans, a horse who baffled Germans 100 years ago by counting and telling the time. Only patient observation by a psychologist found that Hans was no mathematician. His trainer was unconsciously signalling answers to the horse with involuntary cues. The lesson is that it can take study to see who is leading whom.

Unexpectedly, Charlemagne found himself reminded of Clever Hans this week, when watching the defensive positions staked out by European Union leaders—notably in such places as Britain and Poland—in the run-up to their summit in Lisbon. The summit is due to thrash out final demands for changes to a new “reform treaty”, a thinly disguised reworking of the draft constitution rejected by Dutch and French voters in 2005.

Eurocrats usually blame their troubles on cynical Brussels-bashing by national politicians. The politicians, in turn, blame their sceptical voters, or their irresponsible press. But—recall Hans the horse—it is instructive to look carefully at just who, over the years, has been signalling to whom that they should be so wary of Europe. It is a more muddled picture than the Brussels consensus might suggest.

Start with the national politicians. The maddest pre-Lisbon demand came from Britain, where members of Parliament sounded the alarm over a provision that “national parliaments shall contribute actively to the good functioning of the union.” The word “shall”, they fretted, could lead European judges to require them to put the EU's interests above Britain's. In vain, officials insisted that the article was an anti-federalist device added to meet Dutch demands that national parliaments should have more say in Brussels. Desperate to exorcise the spectre of jackbooted gendarmes hauling parliamentarians off their green leather benches to a Luxembourg courtroom, David Miliband, the British foreign secretary, found himself at a pre-summit meeting pleading (successfully) for the word “shall” to be cut.

At the same meeting the Poles displayed a touch of the vapours too. Asked why Poland had followed Britain in seeking a semi-exemption from the Charter of Fundamental Rights (a sweeping list of social and political rights), officials said their government was worried that the charter could force Poland to legalise gay marriage and accept unlimited abortion. The British government wants to minimise the risk that the charter, which enshrines such things as a right to strike, could threaten their liberalising, Thatcher-era labour-law reforms.

Such British and Polish worries provoke much head-shaking in EU circles. The right to strike may be mentioned in the charter, it is said, but the words have no real force: the right to down tools is not in the

EU's gift, as other clauses in other treaties make clear. The charter should be seen more as a cheering “snapshot” of modern European values. It is seen as weird and paranoid to imagine that it could impose something as sensitive as gay marriage on a country—or that Europe would ever try.

So are national politicians silly to worry about being obliged to toe an imaginary EU line? Sometimes, yes. One diplomat this week marvelled that anybody could see a treaty article inviting people to support the “good functioning” of the EU as a legal instruction. It is, he said, a statement of political opinion—it means as much as European politicians agree it means.

But this is an unsatisfying answer to politicians in a place like Britain, where laws mean what they say, and are not deployed as mere slogans. If sweeping declarations in the charter about outlawing discrimination are not meant to overturn national policies, a Pole asks, why are they there? “When we ask what all these big words mean, everybody tells us: nothing special, don't worry. But we should avoid this kind of rhetoric.”

If national governments are paranoid, moreover, they may have good cause. The ever-deeper-union camp has a record of inserting coded language into treaties, so that projects such as monetary union can be revisited later. British officials also have memories of being tricked over opt-outs: in the mid-1990s they secured an exemption from the social chapter, a shopping list of labour and social-policy measures. They have not forgotten that, a few years later, the European Commission circumvented their opt-out by calling a directive to limit the hours employees may work a health-and-safety measure, not a social one.

Paranoid leaders, befuddled voters

And what of voters? The politicians like to blame them and the press for insisting on a defence of red lines at summits. But leaders send their own cues to the voters. Take Britain's Gordon Brown. Challenged in the House of Commons to defend the new treaty, and to explain his refusal to grant a referendum on it (even though one was promised for the constitution), Mr Brown recited the exemptions his government had won: “the opt-out, the protocol, the opt-in and the emergency brake.” He boasted that “we have stood up for the British national interest. That is more than the Conservative Party ever did over Maastricht.”

Yet British voters need not be rabid Europhobes to conclude from this that the new treaty must, in its original, non-red-lined form, have been dangerous. If the British national interest were not under attack, why is it so necessary to stand up for it? Just what terrors does Mr Brown think the Conservatives unleashed by signing the 1992 Maastricht treaty?

It is a muddle, then. This matters because those who are heading to Lisbon this week, from both Brussels and national capitals, believe themselves to be crafting a treaty that will answer the real hopes and fears of European voters. But given the subliminal cues and mixed messages that they are sending out, politicians and Eurocrats can have little confidence that they have any idea what their citizens want. As any behavioural scientist can tell you, if you cannot exclude Clever Hans effects from an experiment, you might as well throw the data away.

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Gordon Brown and Europe

Damned if he does

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Illustration by David Simonds

The embattled prime minister faces a fresh dilemma over the European Union's new reform treaty

FOR a politician acclaimed for his strategic foresight, it is startling that Gordon Brown has been tripped up by events he should have seen coming. The prime minister had ample opportunity to cool speculation over a snap election long before he resolved not to have one, a decision that hastened the resignation of Sir Menzies Campbell, the leader of the Liberal Democrats (see article). Stephen Byers, a former Labour cabinet minister, warned the government that it was vulnerable on the issue of inheritance tax long before the Conservatives announced a popular pledge to raise the threshold for it.

The latest hazard facing the prime minister has also been in his diary for some time. On October 18th he arrived for a summit in Lisbon, where EU leaders hoped to agree on a treaty to replace the constitution rejected by French and Dutch voters two years ago. Mr Brown inherited from Tony Blair not only the treaty, most of which was negotiated before he took office, but also a pesky manifesto commitment to hold a referendum on the original constitution. The Tories say the two documents are very much alike. The House of Commons European Scrutiny Committee (ESC) agrees. Polls show that voters want a referendum on the treaty, and would vote against it.

So Mr Brown finds himself in a fraught position. Were he to call a referendum, campaign for a “yes” vote and lose, his premiership would be damaged, perhaps mortally. But refusing a plebiscite would also be painful. The right-wing press that he assiduously courts would intensify its criticism of him. The Tories would crow that, having faced no opponent for the Labour leadership and ducked a general election, he possesses neither courage nor any kind of mandate. Once fatally divided on Europe, the Tories are now uniformly Eurosceptic and are voicing the public's wish for a say. Even on his own side, he could expect dissent from Eurosceptic MPs such as Frank Field and Gisela Stuart, who describes the government's position on the treaty as “neither honest nor coherent”, as well as from some trade unions.

Opponents of the treaty have grounds for concern. The document is similar to the constitution, with only the ornate preamble and symbolic measures such as a European flag and anthem being jettisoned. Ministers like to point to concessions they claim to have secured in controversial areas, but some of these look vulnerable: the exemption from the Charter of Fundamental Rights has never been tested in court, for example, and some countries mutter about exacting a price for Britain's greater independence on home affairs. On October 16th David Miliband, the foreign secretary, was attacked for accepting these

incursions across Britain's vaunted “red lines” by the ESC chairman, who rashly compared the government's support for the treaty to Neville Chamberlain's enthusiasm for the Munich agreement.

For all that, Mr Brown is likely to conclude that agreeing to ratify the treaty without a referendum is the least bad option. Refusing to do so could plunge relations with the EU into crisis, perhaps forcing a profound debate about Britain's membership. Europe might then dominate the rest of Mr Brown's time in office.

The irony is that, whereas Mr Blair lost his popularity over something he at least believed in (the Iraq war), it is unclear what Mr Brown thinks about Europe, and whether he cares at all. He has Eurosceptic credentials: he resisted Mr Blair's enthusiasm for the euro as chancellor and has yet to visit Brussels four months after becoming prime minister. Ed Balls, the schools secretary and Mr Brown's closest ally, favours a “hard-headed pro-Europeanism”, which some interpret as implying that Mr Blair was naively Europhile. On the other hand, Mr Brown supported Britain's disastrous entry into the Exchange-Rate Mechanism in 1990 and appointed Mr Miliband, a prominent pro-European, as foreign secretary. In opposition, Mr Brown was considered more Europhile than Mr Blair, to say nothing of Robin Cook and Jack Straw, both Eurosceptics at the time who went on to become foreign secretaries.

The advantages of ambivalence

Still, an ambivalent attitude to Europe may be no bad thing. Europhiles and Eurosceptics share an optimistic hope that Britain's relationship with Europe can be settled one way or the other. Mr Blair believed that joining the euro would make Britain a truly European nation, not only comfortable with integration but keen to lead it. Similarly, many opponents of the treaty hope a “no” vote would be the beginning of the end of British membership of the union. Yet it is likely that Britain's approach to the EU will always be that of the reluctant participant: content to remain inside and influence a club that is broadly in its interests, but anxious to avoid integrationist projects wherever possible.

That approach has been successful in the past. Under John Major, Mr Blair's Tory predecessor, Britain secured an opt-out from monetary union but remained sufficiently involved with the EU to secure its enlargement to the east, impeding the “ever closer union” favoured by Europhiles. Under Mr Blair, Britain won further concessions—to the irritation of many in Brussels—without losing its influence. British prodding helped to install the sympathetic José Manuel Barroso as president of the European Commission in 2004.

Such victories do little to assuage the British public, which has not been asked its opinion about the EU since a referendum on Britain's membership in 1975. That Mr Brown's plan is to ratify the treaty without consulting the voters seems clear enough. Whether he can withstand the backlash is less so.

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BAE Systems

Defender of the realm

Oct 18th 2007
From The Economist print edition

Britain's defence champion loses its most successful boss in years

PERHAPS it has something to do with the nature of its business, but there was a time when changing the guard at BAE Systems was a combative affair. From the ousting in 1991 of Sir Roland Smith, a chairman, to the ejection (while on a skiing holiday) in 2002 of John Weston, a chief executive who had thought himself in line for the job of chairman, regicide has been a prime tool of talent management at Europe's biggest defence firm.

So when on October 16th the company announced that Mike Turner, a pugnacious company lifer, would step down as chief executive next year, its statement was scrutinised for any sign that this was an ejection rather than the voluntary retirement he and the company claimed. Observers pointed out that just a few months ago he had told a newspaper he planned to stay in his job for five years or more, and that he had in the past said he hoped to succeed Dick Olver as chairman. The two clashed two years ago when Mr Turner, who describes himself as a “rough guy from the North” of England, said that Mr Olver (a former BP man), didn't understand the defence industry. “They had a robust relationship,” says a company spokesman, playing down the rift. “So do many chairmen and chief executives.”

However abrasive Mr Turner was with colleagues, he was even more uncompromising in his dealings with the outside world. Before he took charge of BAE, the firm seemed unable to get anything right. Big fixed-price projects such as those to build submarines and spy planes were running disastrously late and over budget. In 2001 it posted a loss of £134m ($193m) on sales of £13 billion. And relations were strained with its biggest customer, Britain's Ministry of Defence (MoD). Unless the company shaped up, Whitehall mandarins warned, Britain would buy aircraft carriers from France and invite more foreign firms to set up shop in Britain.

The truculent Mr Turner called the MoD's bluff, refusing to sign new contracts unless the government agreed to pay more for ones that proved unexpectedly difficult. And he threatened to decamp for America, a much bigger defence market, unless the government started treating BAE like a national champion and guaranteeing it the lion's share of future contracts. He won on all these points. Now the government awards procurement contracts that leave the state with more of the risk. And a white paper laying out the government's plans for defence spending over coming decades, published in December 2005, promised BAE a big role in most future defence projects.

Mr Turner has also improved BAE's previously inept project management. Delays and cost overruns seem to be falling, according to the National Audit Office, a spending watchdog. And in focusing on America, now BAE's most important market, he has positioned the company well. Billions of dollars are being spent repairing infantry carriers worn out by the gruelling pace of operations in Iraq and building the mine-resistant patrol vehicles needed to fight insurgents rather than armies. His latest accomplishment was the sale of Eurofighter jets to Saudi Arabia. A similar contract signed more than two decades earlier for Tornado jets produced £43 billion for BAE over the years and provided the profits that allowed it to keep staggering on when just about everything else it touched turned to dross.

Yet for all his achievements, Mr Turner has become a liability. America's Justice Department is probing allegations of bribery relating to BAE's dealings in Saudi Arabia, and British investigators are scrutinising several deals with other nations. Many of these allegations predate Mr Turner's tenure as chief executive, but a change in leadership could do much to convince authorities that they relate to an era that lies firmly in the company's past.

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Abortion

Unsettled issue

Oct 18th 2007
From The Economist print edition

Another debate about who can have one, and when and where and why

BRITAIN may have been spared America's abortion wars but the issue still raises strong passions. Abortion laws are difficult to make, and just as difficult to amend: the 1967 act that legalised abortion was the result of a private member's bill. And in 1990, the only time that law was updated, the changes were tacked on to legislation about fertility treatment.

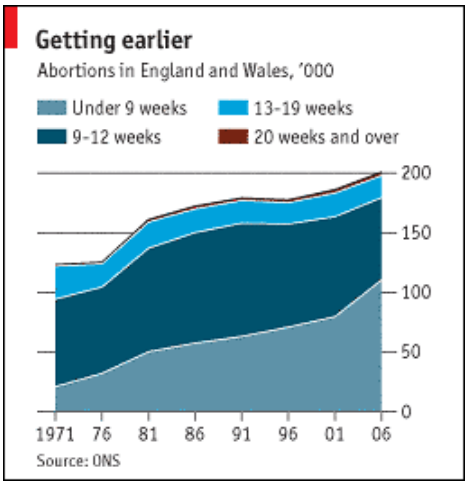
Now all sides of the debate are getting ready for battle once more. The law on fertility treatment is changing next year. Since abortion was included when the original legislation was passed, MPs will be able to bring up the topic this time too. In preparation, the Science and Technology Committee, a cross-party group of MPs, is investigating the matter and started hearings on October 15th.

The committee has drawn its remit tightly, focusing on the science and refusing to address matters moral or ethical. That has drawn criticism. Some of the questions asked—how serious a fetal defect must be for a very late abortion to be allowed, for example—are unanswerable on scientific grounds alone.

One burning issue the committee is considering is whether it should be more difficult to get late abortions. Almost all abortions (97%) are carried out under a single catch-all clause, which permits abortion to protect the woman's physical or mental health. The 1967 act originally set a limit of 28 weeks for such abortions, reasoning that if the cut-off were any later an aborted fetus could otherwise have been born alive. After improvements in neonatal care allowed more premature babies to survive, that limit was cut to 24 weeks in 1990. Some think medical advances since then mean it should be reduced further.

The committee is also looking at ways to make it easier for women who want an abortion to get one as soon as possible. One possibility is to relax the requirement for two doctors' signatures. Another is to allow nurses as well as doctors to carry out abortions in the first three months of pregnancy. With fewer doctors training to do abortions and an inexorable rise in the number of women wanting them (see chart), there is a shortage to be filled. The MPs are also considering whether the rules governing early non-surgical abortion should be relaxed.

Despite the attempt to restrict the debate to the science, submissions have, predictably, divided along ethical lines. Those who believe all abortion is wrong are keen to advance their cause by making it harder to get one. Since they are not allowed to argue on moral grounds, they claim some science is on their side, such as higher rates of depression and mental illness following abortion (the causation is hotly disputed).



Meanwhile, those on the other side of the debate argue that the more paternalistic elements of the original legislation are no longer relevant. What they fear most, however, is that the time limits for abortion may be cut once more. Late abortions are rare, they point out, and, unlike early ones, their number is stable.

Recent research by a team at Southampton University found that many women who had late abortions realised later than most that they were pregnant. Some had been menstruating only irregularly, because they were breastfeeding, or using contraception, or very young or near the menopause. According to Ellie Lee, one of the report's authors, tightening the rules will simply lead to abortion tourism. She points out that women in countries with restrictive laws on late abortions who find themselves in such situations already travel—some to Britain—for abortions rather than carry their babies to term. In such hard cases, science alone cannot illuminate the right approach.

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Cornish

Back from the dead

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From The Economist print edition

The travails of Britain's latest revived language

HOW many nations are there in the United Kingdom? Most people, including most of its residents, will say four—England, Scotland, Wales and Northern Ireland. Yet some inhabitants of Cornwall, a county in England's south-western tip, think the number should be five, arguing that Cornwall should be treated as a separate nation.

As evidence they cite first their county's remoteness: bounded by the sea and separated from the rest of England by the river Tamar. Then there is Cornwall's cultural heritage, in particular the Cornish language, a Celtic tongue closely related to Breton and Welsh. It was dead for centuries, with the last fluent speaker thought to have perished in 1777. But thanks to a revival movement that started in the 1920s, several hundred people speak it today. In 2002 the government recognised Cornish as one of Britain's official minority languages, alongside Welsh, three varieties of Scottish, Irish Gaelic and Manx.

But reviving a dead language is a tricky business, especially when all there is to go on is fragmentary written records. Disagreements among experts have led to schism. Depending on how you choose to count, says Ray Chubb, the secretary of Agan Tavas (“Our Language”), there are either three or four distinct dialects in use today.

After years of often bad-tempered debate, a group of experts met on October 14th to decide on a single, official version of the language. They proposed a compromise, with bits taken from several of the existing dialects, to be considered later this month by the Cornish Language Partnership, a state-funded outfit charged with promoting the language. That was politically wise, since it avoided slighting advocates for any particular dialect. But, notes one observer wryly, it means that until they have had time to learn the new words, none of the existing Cornish speakers will be fluent in their new tongue.

Nevertheless, say supporters, deciding on an official form of the language is worth some short-term pain. The language appears to be spreading, although no one is sure of the precise numbers. A government report in 2000 put the number of fluent speakers at around 300; many more know at least a few phrases. Having one canonical version will make it easier to proselytise, especially in schools: revivalists hope to offer a set of Cornish textbooks to pupils from next year. And, says Mr Chubb, it will mean more money from the government.

Militant supporters hope eventually to emulate Wales, where Welsh is compulsory for schoolchildren and in many government jobs. The wildest dreamers foresee a day when Cornwall is granted independence from England. Officially, as recipients of state funding, Cornish boosters profess no opinion on the subject. “But,” muses Mr Chubb, “learning the language inevitably raises awareness of Cornish history.”

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Literary agents

A tale of glamour, greed and gossip

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Will Britain's oldest literary agency slowly fade away?

CAROLINE MICHEL went to the party on October 16th for the announcement of this year's winner of the Man Booker prize, Britain's poshest literary award, but despite her glamorous looks she was hardly in a festive mood. Ever since September, when she took over as boss of PFD, the country's oldest literary and talent agency, she has been at the centre of a public and acrimonious fight between PFD's owners and its agents. So far 21 of the company's staff of 70 have handed in their resignations. More are toying with the idea of jumping from what some have come to see as a sinking ship.

Ms Michel's arrival as boss of the company, founded in 1924 as A.D. Peters and merged in 1999 with Fraser & Dunlop to become PFD, is not the reason for the mass defection. Staff are unhappy with CSS Stellar, a sports-marketing firm that bought the agency six years ago. CSS knows little and cares less for the business, they say: it just squeezes PFD for short-term profit.

Yet Ms Michel's arrival from William Morris, an American agency, made the row public. PFD agents talked to journalists and other agents and publishers who in turn offered their version of events to the press. PFD's troubles were the hottest topic at the book fair in Frankfurt last week. Great gossip it may be, says Andrew Franklin, publisher of Profile Books, but it is also a Shakespearean tragedy.

The six-year ownership of PFD by CSS was never a happy one, but relations became seriously strained before the summer when a group of more than a dozen of its agents tried to buy the company for around £4m. Board members of CSS, which bought the company for £12m, rejected the offer as far too low. They also claim that PFD's agents have spent the past six years taking big bonuses and commissions for themselves without doing much to expand the business. The thwarted buyers argue that one-third of the CSS acquisition was in shares that are by now pretty worthless. And they feel they deserved their bonuses because they brought in lots of lucrative work.

At present PFD still has many of the best and brightest stars in British literature, theatre and film under contract. It manages the rights of the books, plays and films of Julian Barnes, Ruth Rendell, Tom Stoppard, Keira Knightley and Hugh Grant, among others. But authors, playwrights and actors tend to be loyal to their agents, rather than the firms that employ them. Some of the relationships go far beyond mere business. Pat Kavanagh, for instance, a leading agent and one of the first to resign, is married to Mr Barnes and also looks after Ms Rendell's books.

The agency still has some strong cards to play. PFD may be losing agents, but it retains the valuable backlist, which comprises the rights to books, plays and films that are not part of the current year's budget. These include reprints and film rights for books, new productions of plays, and video and DVD rights for films that have been released on the big screen. The backlist is the bread and butter of the business, as it ensures a steady stream of revenue even when newly published books and recently premiered films are not doing well. Some of the work with the backlist, such as looking after the rights of long-dead poets, is neither lucrative nor exciting, but artists rely on their agents to take good care of their previous work.

The lack of that backlist is the biggest problem for the defectors, who plan to set up a new firm called “United Agents” at the beginning of next year. Without such a source of steady cash, the fledgling firm could struggle. There is talk of trying to buy the backlist from PFD, but an amicable agreement does not look likely. Relations have become so strained that some agents who are working out their notice periods have been locked out of their offices. The defectors suspect that their phones are tapped and their e-mails read.

Ms Michel, meanwhile, has set herself the goal of making PFD a European version of William Morris, which is more aggressive in style and pushes harder for cross-fertilisation among books, films and plays. She wants to expand PFD in Europe, where few authors have agents and most business is done directly with

publishers. But that will be an almost impossible task, as she is losing much of the creative talent that is PFD's biggest asset. She will of course try to hire new agents with a gift for spotting and handling new authors and playwrights. But “the name PFD is toxic now,” says one of the defectors. Authors and actors will think twice about joining an agency that had previously been their first port of call.

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Health-care performance

Now wash your hands

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A focus on targets risks overlooking the basics

EACH year the Healthcare Commission, the watchdog that regulates Britain's health-care providers, publishes a report on the state of the National Health Service. This year's "health check", published on October 18th, contained some good news. The proportion of NHS trusts ranked "excellent" for their quality of care had quadrupled, from 4% to 16%, and fewer were ranked "weak". Ambulances are arriving more quickly; patients are being seen faster in A&E; and waiting times for cancer treatment are falling. And after last year's budgetary difficulties, it was a relief to learn that fewer hospitals are in financial meltdown. More than a third of trusts are now ranked "excellent" or "good" for use of resources, up from just 15% last year.

But the good news was overshadowed by another report published just a week earlier. The commission's investigation into the handling of an outbreak of *Clostridium difficile* at the Maidstone and Tunbridge Wells NHS Trust, which runs three hospitals, made shocking reading. Between April 2004 and September 2006 at least 1,176 patients at the hospital had been infected with the bug. Of the 345 who subsequently died, around 90 had definitely or probably been killed by it. Police are considering charges of criminal negligence or corporate manslaughter.

This nasty disease, caused by a bacterium that infects the gut, leads to severe diarrhoea and can be fatal, particularly to the elderly and those who are already ill. Antibiotics can make it worse by killing off other gut bacteria, leaving more room for nasty ones to multiply. Isolation and scrupulous cleanliness stop it from spreading.

None of this was evident in Maidstone and Tunbridge Wells. The commission heard that nurses in understaffed wards were careless about washing their hands, and sometimes told patients with diarrhoea to "go in their beds" because they were too busy to help them to the lavatory.

Some critics claim that performance-monitoring of the sort reported in the annual health check is at the root of Britain's growing problem with hospital-acquired infections. Targets to cut waiting times encourage hospitals to run at full capacity, rather than carrying out lengthy infection-control procedures between patients. As a representative of patients at the hospitals run by the Maidstone and Tunbridge Wells trust puts it, "When management focuses on financial pressures and government targets it does divert attention away from patient care." On October 17th the leader of the Conservatives, David Cameron, joined the fray. During prime minister's questions in Parliament, he challenged Gordon Brown to admit that "top-down targets" had contributed to the outbreak.

When asked to comment on such claims, the commission's chief executive, Anna Walker, described them as "facile". "Every organisation has to live within its budget," she said. Financial matters were "no excuse" for managers not to regard patient care as their priority. Trusts facing exceptional circumstances can ask the commission to suspend the targets, she pointed out. Maidstone and Tunbridge Wells had made no such request.

Targets did not cause the poor management at the trust, but they were not without effect. According to the Healthcare Commission's own investigation, some infected patients had been moved from one ward to another, apparently in order to help the hospital meet the waiting-time target for treatment in A&E wards.

The trust's first outbreak of the bug passed unnoticed, and even when its managers realised they had a problem, they continued to deny that anyone had died of it. Such denial may reveal a wider problem. Most of the data used in the annual health check are based on self-assessment; the commission checks the data where it has reason to be suspicious and carries out some random checks too. Of the 111 trusts known to be failing to meet standards on infection control, only 99 voluntarily reported this fact. Another 12 claimed to be doing fine. No one knows how many other hospitals are also struggling.

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Immigration

Give and take

Oct 18th 2007
From The Economist print edition

Broad claims about the impact of immigration hide big variations

BOTH the pro- and anti-immigration lobbies pounced with glee on two official reports published on October 16th. Those who delight in Britain's hoovering-up of foreign workers championed a Home Office study which found that immigrants contributed £6 billion to the economy last year and are harder workers than native Britons. Those who fret about foreign freeloaders brandished a separate report—from that very same department—which warned that immigration was putting a strain on services such as housing, health and policing in many parts of the country.

Such is the increase in immigration to Britain that evidence can be found to back up almost any theory about its pros and cons. Immigration started to outweigh emigration in the 1980s and really took off a decade ago, when the government began handing out more work permits, universities wooed international students and applications for political asylum rose (these have since dropped off). At the end of last year foreign-born workers made up 12.5% of the labour force, up from 7.4% in 1997. Today, one in four babies born in Britain has a foreign parent.

Famously, the big increase of recent years has been in Poles, whose numbers have swollen from a little over 50,000 in 1996 to well over 300,000 (and some say twice that). But nearly every nationality is now present in greater numbers than before: during the same period, Britain's French population nearly doubled; Sri Lankans and Filipinos more than trebled. Britain is importing not only more workers to perform undesirable “3D” jobs—those that are dirty, dangerous and difficult—but also more high-fliers on super-salaries.

In terms of earnings, the most successful are the Americans (see table), who command higher wages and work longer hours than any other immigrant group. Canadians, Australians and South Africans are the next-biggest earners, according to a report released last month by the Institute for Public Policy Research, a leftish think-tank. Yet rich countries do not always produce the richest migrants, points out Danny Sriskandarajah, the report's author: Nigerians fare better than Portuguese, and Ugandans earn nearly twice as much as Turks.

League of nations

Social profile of British workforce by country of birth, 2005-06

	Age leaving education	Employment, %	Annual income £'000	Home ownership, %	Social housing, %
France	21.5	86	25.6	67	5
Nigeria	21.0	76	21.6	50	29
United States	21.0	81	37.3	75	5
Poland	20.5	85	15.8	67	8
China	19.5	69	19.7	75	9
India	19.5	71	23.2	86	8
Britain	**17.5**	**78**	**21.3**	**75**	**17**
Pakistan	17.5	45	19.5	75	15
Somalia	17.5	19	13.7	4	80
Portugal	16.5	70	16.3	37	40

Source: Institute for Public Policy Research

A migrant's fortunes are largely determined by his reason for coming to Britain. Australians, Poles and Filipinos, who come primarily for jobs, are employed in far greater proportion than British-born residents. By contrast, some new arrivals are legally prevented from working: Somalis' woeful 19% employment rate is partly down to the fact that many start off as asylum-seekers, who cannot work until their application is cleared, usually after more than six months. Others move to Britain to join family members or to marry.

Half of all Pakistan-born residents are economically inactive, thanks in part to the fact that many come in order to start families rather than careers.

Whatever the prospects of recent arrivals, they do not necessarily predict how the next generation will fare. Achievement at school is usually linked to family income, so one might expect children from poorer immigrant backgrounds to slip up. But they don't. Immigrants from China earn less than the national average and are less likely to be in work, but their children trounce all comers at school—and are hotly followed by children classified as Indian or “other Asian”.

Immigrants from most countries spend longer in full-time education than Britons. For first-generation migrants, this often fails to translate into higher wages. But it seems to give a heck of a boost to their children—and it is on them that the success or failure of Britain's immigration experiment will ultimately depend.

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Bagehot

Memento mori

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From The Economist print edition

Illustration by Steve O'Brien

What Ming Campbell's demise tells Gordon Brown about the new demands of political leadership

IF HE survives the European summit, Gordon Brown will be at the rugby World Cup final between England and South Africa in Paris on October 20th. Scottish though he is, Mr Brown and the English team are a natural fit. Compared with the pharaonic lifestyles of England's football players, the rugby lot are understatedly modest. Their star is a teetotal workaholic. Like Mr Brown himself, many of them are grizzled leftovers of a more glamorous era. They have succeeded not through verve and skill but grim, unflashy hard work, which their fans seem to prefer.

So the ideal of Englishness embodied in the team mirrors the idea of leadership that Mr Brown has tried to promote. Unfortunately for him, although both are close relatives of war, the ingredients of success in sport and politics are rather different—witness the demise of Sir Menzies “Ming” Campbell, Mr Brown's friend and ex-leader of the Liberal Democrats.

Blood will have blood

Sir Ming's is a cautionary tale of the perils and demands of modern political leadership. He resigned, on October 15th, after less than 18 months in the job, blighted by an ancient dilemma of British politics: the difficulty third parties face in making their voices heard, let alone winning power. He was squeezed down and out by the Tory revival under David Cameron and the departure of warmongering Tony Blair, which boosted Labour. But newer realities were just as important. One is the growing presidentialism of politics, in which the policies the Lib Dems developed under Sir Ming were obscured by his own performance. Another is the criteria by which leaders are now judged.

Conventional wisdom, to which Sir Ming himself subscribes, has it that his age was his undoing. Though only marginally older, at 66, than Winston Churchill was in 1940, mean political cartoonists portrayed Sir Ming in a wheelchair, behind a Zimmer frame or as a skeleton. The implication is that politics is now a youngsters' game, destined to be dominated by thirty-something apparatchiks who rise without a trace through think-tanks and special-adviserships.

Troubling as that interpretation is, it is in a way a consoling one for Sir Ming. The truth is less exculpating for him, and more worrying for Mr Brown. Sir Ming flopped less because he is old than because he is uncharismatic—at least, not charismatic in the ways that 21st-century politicians are called upon to be.

They need, it increasingly seems, to conform to certain minimum physical standards: bald pates and paunches are out. They need a user-friendly “vision”, a soundbite-sized theme of their leadership. Having a good “back story”—as does Sir Ming, a former Olympic sprinter, and as Mr Brown thinks he does too—does not compensate for failure on these scores.

These twin demands can be traced to the ascent of JFK, but have been magnified by an ever-more relentless media: with all their weaknesses exposed and judged instantly, politicians need the appeal of reality-television stars, as well as the gritty stamina of rugby players. On that basis the Lib Dems' best bet for Sir Ming's replacement—to be determined by a ballot in December—is probably Nick Clegg, a photogenic if inexperienced MP. Churchill, who understood the importance of visions and themes, might have scraped through these tests (“Take away this pudding,” he once told a waiter, “it has no theme”). But Clement Attlee, another great leader, probably wouldn't. Septuagenarian Ronald Reagan did; Bob Dole didn't. Does Mr Brown?

Another pertinent lesson of Sir Ming's short and nasty tenure may be that the top job in any party is a different and sterner challenge than a departmental brief. Sir Ming was previously a principled and sane critic of the government's foreign policy; but as leader he was called upon to be a generalist, and to be decisive and inspirational. He is not the first, in opposition or government, to be confounded by this gap: some undistinguished ministers, such as Churchill or Margaret Thatcher, sailed over it; some accomplished ones, such as Anthony Eden, sank into it. Will Mr Brown?

Of course, leaders of the Lib Dems are different to prime ministers: the public assesses them more as entertainers and less as prospective statesmen. While the average political life expectancy of a British opposition leader is now only a couple of years, if they avoid economic disasters prime ministers can stick around much longer. They have greater scope to rescue their reputations than unfortunates such as Sir Ming, who decided that his had become unsalvageable. But there is one other aspect of his unhappy experience that Mr Brown ought to ponder. It is that, in politics, blood will have blood.

After Mr Brown “bottled” the autumn election, postponing it until 2009 at the earliest, Sir Ming was always likely to go. By resigning when he did, he avoided the grisly assassination that disposed of his predecessor Charles Kennedy in 2006. But his going was accelerated by whispering among a few of his colleagues and silence among most of the rest. Backstabbing is becoming acceptable behaviour among the Lib Dems, and regicide threatening to become a habit, as it did for the Tories after Lady Thatcher's “murder”. Will it also do so for Labour? A few early grunts of discontent among acolytes of Mr Blair this week may anticipate noisier eruptions to follow, especially if Mr Brown fails to turn around his party's fortunes (and poll ratings).

Conventional wisdom also has it that Sir Ming's exit is good news for Mr Brown, since a fresher Lib Dem leader will win back voters who have drifted to the Tories. Perhaps. But Sir Ming's failed leadership may also prove ominous for the prime minister. Lib Dem power struggles can be hard to take seriously, feeling to outsiders more like comic operas than genuine tragedies. This one may conceivably turn out to be a masque that foretells the plot of a bigger drama to follow.

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The Western alliance

Shadows over NATO

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From The Economist print edition

Reuters

The war in Afghanistan is straining the West's military alliance

Get article background

THE NATO alliance likes to boast it has won every battle in Afghanistan, forcing the Taliban to resort to “asymmetric” suicide bombings. Perhaps. But NATO is far from winning the war, and the ragged Afghan insurgents seem to have more staying power than the West's mighty alliance.

As defence ministers prepare to meet in the Netherlands on October 24th, NATO itself is looking shaky. Last year, when southern Afghanistan erupted in intense violence, NATO asked for more troops and said the contingents already there should do more to help the countries leading the combat, mainly America, Britain and Canada. This year, with casualties higher than in 2006, NATO's concern is no longer to increase its strength but to stop some allies from withdrawing altogether.

The Dutch centre-left coalition government is prevaricating over whether to extend the mission of its troops beyond 2008. It wants to find another country with which to share the burden of securing the restive province of Uruzgan.

In Canada, the minority conservative government of Stephen Harper is under pressure from all three opposition parties—Liberals, Bloc Québécois and the New Democrats—to withdraw its soldiers by February 2009. Canada provides the main force in Kandahar. On October 16th the government said troops should stay in Afghanistan until 2011, although it was unclear whether they would remain in a combat role or scale back to a training mission. Four days earlier, Mr Harper had appointed a special panel to draw up by February 2008 non-binding recommendations for the mission's future.

After a heated debate, the German parliament voted this month to maintain its troops for another year. In Italy the debate over its contingent has been re-opened by the kidnapping last month of two Italian intelligence agents, one of whom was fatally wounded in a rescue operation.

Main troop-contributing nations*

United States	15,108
Britain	5,291
Germany	3,155
Italy	2,395
Canada	1,730
Netherlands	1,516
Turkey	1,220
France	1,073

Source: ISAF *Current as of Oct 14th

The United Nations' special envoy to Afghanistan, Tom Koenigs, told the Security Council last week that the NATO-led International Security Assistance Force (ISAF) was the Afghan government's best defence against the Taliban. “Because of this, nations should resist the temptation to reduce their commitment,” he said. “Now is not the time to wobble.”

Just as NATO is vital to Afghanistan, so Afghanistan is vital to NATO. General Dan McNeill, the American commander of ISAF, has given warning that the alliance's future is at stake in the country. He said the allies had the “upper hand”, but did not have enough forces, whether foreign or Afghan, to hold on to all the ground they wrest from insurgents.

Unable to find more battalions, NATO is changing its emphasis: it now wants to step up the training of Afghan army and police units, and to deploy more Operational Mentor and Liaison Teams (OMLTs or “omelettes”). These are groups of Western soldiers embedded within Afghan units to improve their fighting abilities, and call in support such as air strikes.

These may be more palatable for some governments, but many are in any case short of troops, given other peacekeeping commitments. NATO's much-heralded “reaction force”—a 25,000-strong body of troops ready to deploy within days—is already being scaled back less than a year after being officially declared operational.

NATO sees two rays of hope. The departure of the British from Iraq, and America's likely draw-down there, might eventually release more forces for Afghanistan. And the election of a more American-friendly French president, who has talked of rejoining NATO's integrated military structure, could provide a boost to the alliance. It needs one.

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Education

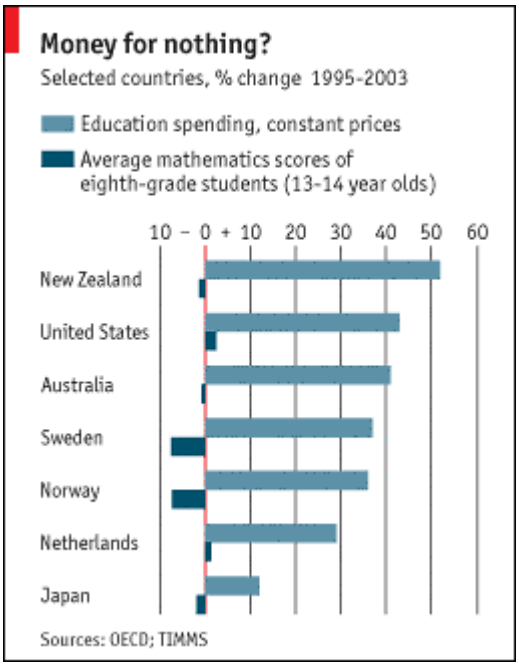
How to be top

Oct 18th 2007
From The Economist print edition

What works in education: the lessons according to McKinsey

THE British government, says Sir Michael Barber, once an adviser to the former prime minister, Tony Blair, has changed pretty much every aspect of education policy in England and Wales, often more than once. “The funding of schools, the governance of schools, curriculum standards, assessment and testing, the role of local government, the role of national government, the range and nature of national agencies, schools admissions”—you name it, it's been changed and sometimes changed back. The only thing that hasn't changed has been the outcome. According to the National Foundation for Education Research, there had been (until recently) no measurable improvement in the standards of literacy and numeracy in primary schools for 50 years.

England and Wales are not alone. Australia has almost tripled education spending per student since 1970. No improvement. American spending has almost doubled since 1980 and class sizes are the lowest ever. Again, nothing. No matter what you do, it seems, standards refuse to budge (see chart). To misquote Woody Allen, those who can't do, teach; those who can't teach, run the schools.



Why bother, you might wonder. Nothing seems to matter. Yet something must. There are big variations in educational standards between countries. These have been measured and re-measured by the OECD's Programme for International Student Assessment (PISA) which has established, first, that the best performing countries do much better than the worst and, second, that the same countries head such league tables again and again: Canada, Finland, Japan, Singapore, South Korea.

Those findings raise what ought to be a fruitful question: what do the successful lot have in common? Yet the answer to that has proved surprisingly elusive. Not more money. Singapore spends less per student than most. Nor more study time. Finnish students begin school later, and study fewer hours, than in other rich countries.

Now, an organisation from outside the teaching fold—McKinsey, a consultancy that advises companies and governments—has boldly gone where educationalists have mostly never gone: into policy recommendations based on the PISA findings. Schools, it says*, need to do three things: get the best teachers; get the best out of teachers; and step in when pupils start to lag behind. That may not sound exactly “first-of-its-kind” (which is how Andreas Schleicher, the OECD's head of education research, describes McKinsey's approach): schools surely do all this already? Actually, they don't. If these ideas were really taken seriously, they would change education radically.

Begin with hiring the best. There is no question that, as one South Korean official put it, “the quality of an education system cannot exceed the quality of its teachers.” Studies in Tennessee and Dallas have shown that, if you take pupils of average ability and give them to teachers deemed in the top fifth of the profession, they end up in the top 10% of student performers; if you give them to teachers from the bottom fifth, they end up at the bottom. The quality of teachers affects student performance more than anything else.

Yet most school systems do not go all out to get the best. The New Commission on the Skills of the American Workforce, a non-profit organisation, says America typically recruits teachers from the bottom third of college graduates. Washington, DC recently hired as chancellor for its public schools an alumna of

an organisation called Teach for America, which seeks out top graduates and hires them to teach for two years. Both her appointment and the organisation caused a storm.

A bias against the brightest happens partly because of lack of money (governments fear they cannot afford them), and partly because other aims get in the way. Almost every rich country has sought to reduce class size lately. Yet all other things being equal, smaller classes mean more teachers for the same pot of money, producing lower salaries and lower professional status. That may explain the paradox that, after primary school, there seems little or no relationship between class size and educational achievement.

McKinsey argues that the best performing education systems nevertheless manage to attract the best. In Finland all new teachers must have a master's degree. South Korea recruits primary-school teachers from the top 5% of graduates, Singapore and Hong Kong from the top 30%.

AP

Asian values or good policy?

They do this in a surprising way. You might think that schools should offer as much money as possible, seek to attract a large pool of applicants into teacher training and then pick the best. Not so, says McKinsey. If money were so important, then countries with the highest teacher salaries—Germany, Spain and Switzerland—would presumably be among the best. They aren't. In practice, the top performers pay no more than average salaries.

Nor do they try to encourage a big pool of trainees and select the most successful. Almost the opposite. Singapore screens candidates with a fine mesh before teacher training and accepts only the number for which there are places. Once in, candidates are employed by the education ministry and more or less guaranteed a job. Finland also limits the supply of teacher-training places to demand. In both countries, teaching is a high-status profession (because it is fiercely competitive) and there are generous funds for each trainee teacher (because there are few of them).

South Korea shows how the two systems produce different results. Its primary-school teachers have to pass a four-year undergraduate degree from one of only a dozen universities. Getting in requires top grades; places are rationed to match vacancies. In contrast, secondary-school teachers can get a diploma from any one of 350 colleges, with laxer selection criteria. This has produced an enormous glut of newly qualified secondary-school teachers—11 for each job at last count. As a result, secondary-school teaching is the lower status job in South Korea; everyone wants to be a primary-school teacher. The lesson seems to be that teacher training needs to be hard to get into, not easy.

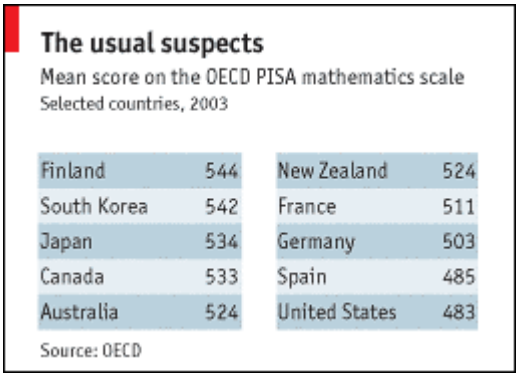
Teaching the teachers

Having got good people, there is a temptation to shove them into classrooms and let them get on with it. For understandable reasons, teachers rarely get much training in their own classrooms (in contrast, doctors do a lot of training in hospital wards). But successful countries can still do much to overcome the difficulty.

Singapore provides teachers with 100 hours of training a year and appoints senior teachers to oversee professional development in each school. In Japan and Finland, groups of teachers visit each others' classrooms and plan lessons together. In Finland, they get an afternoon off a week for this. In Boston, which has one of America's most improved public-school systems, schedules are arranged so that those who teach the same subject have free classes together for common planning. This helps spread good ideas around. As one educator remarked, “when a brilliant American teacher retires, almost all of the lesson plans and practices that she has developed also retire. When a Japanese teacher retires, she leaves a legacy.”

Lastly, the most successful countries are distinctive not just in whom they employ so things go right but in what they do when things go wrong, as they always do. For the past few years, almost all countries have begun to focus more attention on testing, the commonest way to check if standards are falling.

McKinsey's research is neutral on the usefulness of this, pointing out that while Boston tests every student every year, Finland has largely dispensed with national examinations. Similarly, schools in New Zealand and England and Wales are tested every three or four years and the results published, whereas top-of-the-class Finland has no formal review and keeps the results of informal audits confidential.



But there is a pattern in what countries do once pupils and schools start to fail. The top performers intervene early and often. Finland has more special-education teachers devoted to laggards than anyone else—as many as one teacher in seven in some schools. In any given year, a third of pupils get one-on-one remedial lessons. Singapore provides extra classes for the bottom 20% of students and teachers are expected to stay behind—often for hours—after school to help students.

None of this is rocket science. Yet it goes against some of the unspoken assumptions of education policy. Scratch a teacher or an administrator (or a parent), and you often hear that it is impossible to get the best teachers without paying big salaries; that teachers in, say, Singapore have high status because of Confucian values; or that Asian pupils are well behaved and attentive for cultural reasons. McKinsey's conclusions seem more optimistic: getting good teachers depends on how you select and train them; teaching can become a career choice for top graduates without paying a fortune; and that, with the right policies, schools and pupils are not doomed to lag behind.

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*How the world's best performing schools systems come out on top. McKinsey & Co.

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Abortion and the law

Safe, legal and falling

Oct 18th 2007
From The Economist print edition

Restrictive laws do not reduce abortion

WHEN Catholic clergy or “pro-life” politicians argue that abortion laws should be tightened, they do so in the belief that this will reduce the number of terminations. Yet the largest global study of abortion ever undertaken casts doubt on that simple proposition. Restricting abortions, the study says, has little effect on the number of pregnancies terminated. Rather, it drives women to seek illegal, often unsafe backstreet abortions leading to an estimated 67,000 deaths a year. A further 5m women require hospital treatment as a result of botched procedures.

In Africa and Asia, where abortion is generally either illegal or restricted, the abortion rate in 2003 (the latest year for which figures are available) was 29 per 1,000 women aged 15-44. This is almost identical to the rate in Europe—28—where legal abortions are widely available. Latin America, which has some of the world's most restrictive abortion laws, is the region with the highest abortion rate (31), while western Europe, which has some of the most liberal laws, has the lowest (12).

The study, carried out by the Guttmacher Institute in New York in collaboration with the World Health Organisation (WHO) and published in a British medical journal, the *Lancet*, found that most abortions occur in developing countries—35m a year, compared with just 7m in rich countries. But this was largely a reflection of population size. A woman's likelihood of having an abortion is similar whether she lives in a rich country (26 per 1,000) or a poor or middle-income one (29).

Lest it be thought that these sweeping continental numbers hide as much as they reveal, the same point can be made by looking at those countries which have changed their laws. Between 1995 and 2005, 17 nations liberalised abortion legislation, while three tightened restrictions. The number of induced abortions nevertheless declined from nearly 46m in 1995 to 42m in 2003, resulting in a fall in the worldwide abortion rate from 35 to 29. The most dramatic drop—from 90 to 44—was in former communist Eastern Europe, where abortion is generally legal, safe and cheap. This coincided with a big increase in contraceptive use in the region which still has the world's highest abortion rate, with more terminations than live births.

The risk of dying in a botched abortion is only part of a broader problem of maternal health in poor countries. Of all the inequalities of development, this is arguably the worst. According to a report published this week by Population Action International, a Washington-based lobby group, women in poor countries are 250 times more likely to die in pregnancy or childbirth than women in rich ones. Of the 535,000 women who died in childbirth or from pregnancy-related complications in 2005, 99% were in developing countries, according to another report by a group of UN agencies, including WHO, also out this week. Africa accounted for more than half such deaths.

As the UN report noted, countries with the highest levels of maternal mortality have made the least progress towards reducing it. A woman in Africa has a one in 16 chance of dying in pregnancy or childbirth, compared with one in 3,800 for a woman in the rich world.

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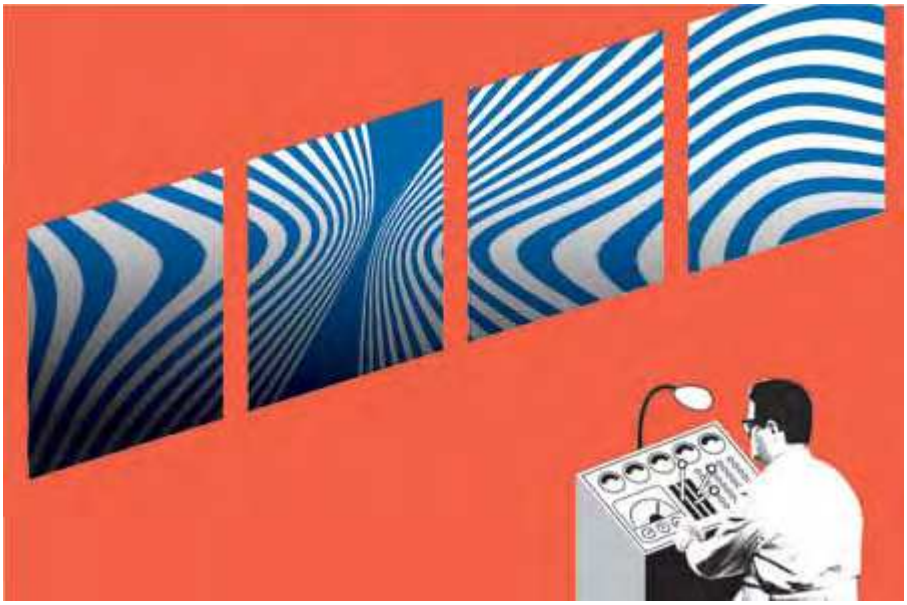
Only human

Oct 18th 2007
From The Economist print edition

Illustration by Dettmer Otto



The turmoil in financial markets has posed hard questions for central banks. Their reputations are now staked on their answers

“THIS is manna. I am blown away. These guys get it.” All decibels and splutters, Jim Cramer, CNBC's markets pundit, was cheering the Federal Reserve's decision on September 18th to cut short-term interest rates by half a percentage point. That bold stroke would bring the credit markets back to life after the nastiest shock in at least a decade. It would, he shrieked, get people to start selling, shopping and hiring. “I could hug these guys,” he yelled. “This is what we wanted.”

Mr Cramer makes a career out of exaggeration. But he is not alone in concluding that the financial world can at last begin to put a miserable summer behind it; and that the turning-point came when the rich economies' central banks showed that they would use interest rates to keep the economic engines roaring. Since the Fed's cut, equity markets have scaled new records, and even junk debt is starting to find a few buyers. Hallelujah! Good job! Lesson learnt! as Mr Cramer might say. The whole ghastly episode was proof that central banks are blessed with great power and that they should use it if need be.

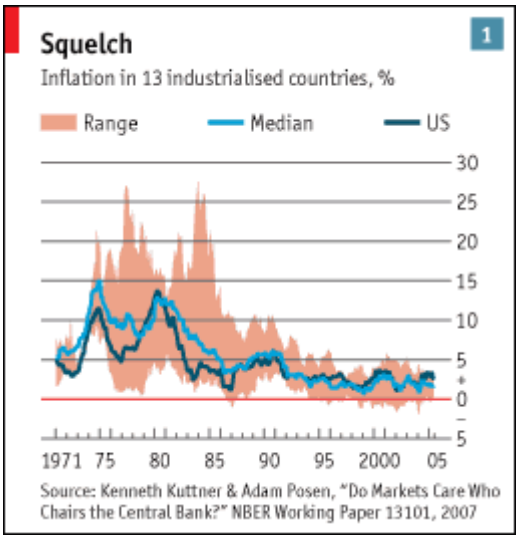
If only life were so simple. In reality, the credit crisis has presented central banks with their greatest challenge since they won the battle against inflation a generation ago. It has cast doubt on how well they have discharged their twin duties as the guardians of financial stability and as the defenders of price stability. It poses questions about whether the almost mystical status that they have acquired over the past two decades can endure—and whether it would be a good thing if it did.

A great deal rests on those questions. A brilliantly inventive generation has harnessed computing power and financial theory to transform the world of finance. Trillion-dollar global markets have sprung up on the back of techniques for converting loans, interest payments, default risk and who knows what else into new securities that could be chopped up and repackaged in mind-boggling combinations, sold and resold. Much good has come of that—and not only fat bonuses on Wall Street and in the City. The most valuable result of the new finance is that more people and businesses have gained access to credit on better terms.

But this summer has shown how far invention has raced ahead of intervention. Vital parts of the new finance take place in lightly supervised markets, as far from the glare of regulators as its practitioners can profitably get. That should be no surprise: regulation imposes costs, restricts innovation and slows people down. Yet, with devastating speed, the crisis spread back into the heart of the most regulated parts of the financial system, the interbank markets and the market for central-bank reserves, which

obliged the central banks to provide liquidity. It even caused scares about the stability of banking systems.

Fixing this will not be easy. At one extreme, to ignore regulatory lessons and just bail out the financiers would be to invite an even more severe crisis next time round. At the other, an over-zealous tightening of regulation would extract a vast cost in lost opportunities for the wise use of the new techniques to make people better off. Regulation spawns innovation to avoid it. Perversely, some of what happened this summer was the unintended consequence of previous regulation.



As for financiers, so for the economy as a whole. As chart 1 shows, the Great Inflation of the late 1970s gave way to an age of low, steady inflation thanks in large part to the skill with which central banks learnt to steer policy. The anchoring of inflationary expectations at moderate levels in turn combined with technological change and globalisation to support strong, steady economic growth. And in both America and Europe unemployment fell below the rates at which economists used to think inflation would start to rise.

A question of credibility

Central banks' success in controlling inflation has won them credibility as economic managers. But that credibility is now at risk in two ways. First, those banks, and in particular the Fed, must take some of the blame for their part in stoking the appetite for risk. Monetary policy was too loose for too long, helping to pump up housing markets in America and elsewhere.

The second threat to credibility rests on how central banks use monetary policy to help clear up the credit mess. In America, where growth and jobs are most at risk, Alan Greenspan, chairman of the Fed until last year, has put the chance of recession at more than one in three. Amid the anxiety, interest-rate increases in Canada, Europe and Japan have been shelved.

The central banks have a difficult balance to strike. If policy is too tight, they will be held responsible for creating recessions. If it is too loose, their grip on inflation could slip, as markets and the public cease to believe that prices will remain stable.

The great paradox is that the central banks' mastery of inflation has made the task of keeping financial markets safe all the harder. When people are confident that inflation is low and will remain so, they may be more prepared to take on debt. That leads to an expansion of credit and the pursuit of more exotic rewards by lenders. It feeds price rises in assets such as housing and securities. It encourages excessive risk-taking. If so, how can you contain inflation without sparking occasional but dangerous bouts of insanity in asset markets? That is a riddle likely to test central bankers for a long time to come.

The central banks' unprecedented public standing, which helped them in the fight against inflation, has also proved a double-edged sword. Blind faith that the Fed will always save the day encourages people to take even greater risks. Greed, unless it is reined in by fear, reaches out towards the calamitous moment when the central bankers' defences fail.

Central bankers themselves are realistic about their knowledge and their powers. Donald Kohn, a Fed governor, put it with admirable honesty in December last year: “In informal terms, we are uncertain about where the economy has been, where it is now and where it is going.” But many financial speculators cling to the idea that central banks are omnipotent. For the sake of everyone else, they should be disabused before they venture into even greater excess.

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CSI: credit crunch

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From The Economist print edition

Central banks have played a starring role

Illustration by Dettmer Otto

THE upheaval that began more than two months ago has been called not only a subprime crisis but also a banking crisis, a crisis of liquidity and a crisis of collateral. It has been each of those things, but most of all it has been a crisis of central banking.

The central banks were present at the creation, as asset prices inflated and credit markets hypertrophied. Between 1997 and 2006, according to the S&P/Case-Shiller national home-price index, American house prices rose by 124%. America's was not the frothiest housing market: in the same period prices in Britain went up by 194%, those in Spain by 180% and those in Ireland by 253%. What was peculiar to America was the ability of large numbers of subprime borrowers—those with poor credit records—to take out mortgages and buy homes, lured by cheap credit and the belief that house prices could only rise. By 2006 a fifth of all new mortgages were subprime. The interest rates on many of these were adjustable, unlike those on most American mortgages. Low “teaser” rates were charged for a while before higher, market-based rates kicked in.

Meanwhile, financial assets of all sorts, from credit-card receivables to companies' debt repayments, had been turned into securities that could be bought and sold. Mortgages—both subprime and mainstream—were no exception. Lenders no longer needed to keep loans on their books, but could sell bundles of them to banks and investment funds at home or abroad. Properly designed, these complicated instruments could be stamped “AAA” by helpful rating agencies. And, like any other security, they could be used as collateral by their buyers when raising loans. By divorcing lenders from the risk of default, securitisation reduced their incentives to look carefully at their borrowers: at times one side or the other, or both, descended to outright fraud. And no one, least of all financial regulators, could be quite sure who in the global financial system was on the hook for which risks.

Central banks were also caught up in the storm when it finally broke. For months central bankers had been giving warning that many risks in the financial system were underpriced. But they were ignored as the financial markets shrugged off one jitter after another. And when the crisis came, on August 9th, it struck in an entirely unexpected quarter. Overnight interbank rates in the euro zone had spiked to 4.6% on August 8th, having been close to 4% shortly before. The next day the European Central Bank (ECB) astonished the financial world by injecting €95 billion ($131 billion) into the money markets—more than it did after the attacks on September 11th 2001. Over the following weeks both the ECB and the Fed poured large amounts into the interbank markets.

The first crisis to test the new world of finance showed that markets are so interconnected and so global that the poison can spread across markets and continents with terrifying speed. After all, the interbank markets lie deep within the financial economy—the closest thing to central-bank money itself. It is a long way from the shabby hoardings of American subprime mortgages to the marbled halls of the European interbank market. It was as if the ambush of a few legionnaires in the forests of Germania had triggered a revolution in ancient Rome.

The moment of truth

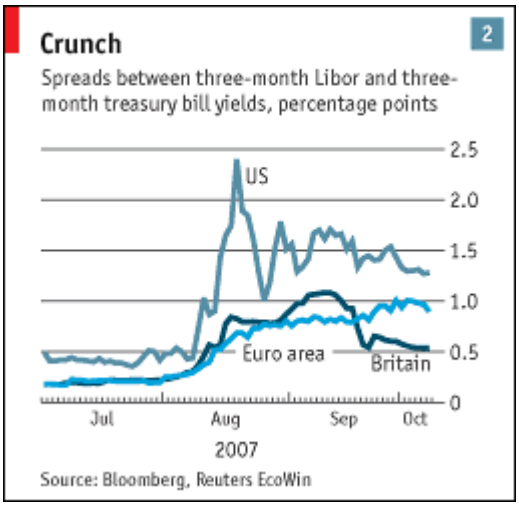
With hindsight, it is clear that the rot started when the teaser rates ran out and the American housing market slowed. Subprime defaults started to climb. In June Moody's, a rating agency, cut the ratings of 131 securities backed by subprime mortgages and said it was reviewing the grades of 136 others. Two hedge funds run by Bear Stearns, an investment bank, were found to have suffered huge losses on

subprime-backed securities. More bad news made such securities increasingly hard to value and harder still to borrow against or sell. In August France's biggest bank, BNP Paribas, tightened the screws by suspending withdrawals from three investment funds, blaming “the complete evaporation of liquidity in certain market segments of the US securitisation market”.

Eventually, the infection spread from managed funds to the banks' own books. It proved just as virulent in Europe as in America. Banks feared they would be on the line when their off-balance-sheet subsidiaries, known as conduits, found that they could not sell asset-backed commercial paper. The German authorities were forced to bail out IKB Deutsche Industriebank, a small lender.

In August the banks deserted each other. In particular, they raised three-month interbank rates, indicating their reluctance to lend to each other for anything but very short periods. The spread between those rates and the rate on government bills, a measure of the perceived riskiness of lending to other banks, rose in Europe—and especially sharply in America (see chart 2). Banks were reluctant to lend to each other because they did not know which counterparties might prove bad credit risks. Moreover, they had good cause to hoard their own cash, because they feared that they might have to rescue their own troubled conduits, or bring their subsidiaries' assets back on to their balance sheets.

Just as central banks had a hand in the events that led up to the crisis, so they have been intimately involved in clearing up the mess. The credit crunch presented central bankers with dual dilemmas, one for each of their two jobs. The first of these is to keep the financial system working smoothly by ensuring that the banking system has enough liquidity. If the system gets jammed, credit will become scarce and market interest rates will rise—and the economy may become jammed too. On the other hand, pumping in liquidity too eagerly may create moral hazard: if banks think that central banks will bail them out come what may, they will be more inclined to lend recklessly.



Central banks' second function is macroeconomic stabilisation, setting interest rates to keep inflation in check without causing the economy to stop and start. Because a credit squeeze raises market interest rates, it will slow the economy down. On the other hand, if a central bank responds by cutting official interest rates too drastically, it may push up inflation, or cause expectations of future inflation to rise. The medium-term goal of price stability might be put at risk.

In seeking to resolve these dilemmas, central bankers have tried to keep their two tasks separate. That is a hard distinction to sustain. Although liquidity crises are short-term emergencies and macroeconomic stability is a medium-term goal, locked credit markets soon have wider economic effects.

In these days of collateralised-debt obligations and residential mortgage-backed securities, there is no textbook to tell central bankers exactly what to do when liquidity in the interbank market dries up. They can call on an ancient guide, in the shape of Walter Bagehot's book, “Lombard Street: A Description of the Money Market”, published in 1873. Bagehot advised the Bank of England to lend freely to illiquid but solvent banks against good collateral, at a penal rate.

But Bagehot was writing long before today's sophisticated interbank market was shaped. Some economists have argued that this market makes his prescription obsolete: there is no need for a central bank to save a solvent but illiquid bank, they say, because the interbank market does the job instead. But what happens if the interbank market itself seizes up?

Different central banks dealt with the double dilemma in different ways. On the liquidity side, the Fed, the ECB and the Bank of England all said that they had no intention of bailing out irresponsible lenders. However, the Bank of England took a much sterner line than the ECB or the Fed.

In mid-August the Fed supplied enough liquidity to hold the effective federal funds rate, an overnight interbank rate, below its then target of 5.25%. It reduced the discount rate, at which banks finding themselves short of cash can, in the spirit of Bagehot, borrow from the central bank, and lengthened the term for which it would lend. Banks were reluctant to go to the discount window at first, but borrowing had picked up by mid-September as necessity outweighed stigma. The ECB also held several special tenders to pump liquidity into the euro area's system.

The Bank of England ended up in a muddle. At first it sat aloof, despite angry requests from banks to unblock the interbank market. Its governor, Mervyn King, set out his reasons in a paper sent to a parliamentary committee on September 12th. Providing greater short-term liquidity might ease the taking back of assets on to banks' balance sheets and hence bring down interbank rates. But it would also undermine the efficient pricing of risk by providing insurance, after the event, for risky behaviour. “That encourages excessive risk-taking,” he wrote, “and sows the seeds of a future financial crisis.” Liquidity should be provided only if withholding it would be so costly to the economy that the moral hazard could be ignored.

At that time, Mr King did not think that point had been reached, but added: “The path ahead is uncertain.” And indeed the day after Mr King's memo reached MPs, it emerged that Northern Rock, a mortgage lender especially reliant on the money markets for its funding, would be granted an emergency line of credit by the central bank. But the news, far from reassuring anyone, sparked a run on Northern Rock, Britain's first bank run since the 1860s, and caused all manner of wild worries about the whole British banking system. The government managed to stop depositors queuing to withdraw their savings only by guaranteeing all their money.

On September 19th the Bank of England changed its mind about three-month money, saying that it would inject up to £10 billion ($20 billion) into the market after all. Mr King made a good fist of explaining the central bank's actions before the parliamentary committee the next day. But the about-turn on three-month money made it look inconsistent, and the Northern Rock affair has damaged its public standing, even if the government and the Financial Services Authority, Britain's banking supervisor, were also at fault.

The twists did not end there. When the Bank of England offered its funding to the market on September 26th, it had no bidders. You could call that a vindication of Mr King's original position: the money was not needed after all. By the time of the auction, three-month interbank rates had fallen back to well below the 6.75% set by the central bank. Then again, rates may have fallen partly because Mr King had made the offer. Or banks may have spurned the auction because they were afraid that the market might find out who had borrowed: if so, they clearly did not need it badly enough to risk shame. Perhaps some straitened banks found the money on better terms elsewhere. An ECB auction the same day shifted €50 billion of three-month money.

The lesson to be drawn from this is that moral hazard is hard to avoid once conditions get really tight. Ben Bernanke, the governor of the Fed, and Jean-Claude Trichet, his counterpart at the ECB, may have erred on the slack side, but at least they have looked consistent. Mr King's position of principle crumpled on impact.

The monetary-policy dilemma has so far proved less testing, at least for central banks that had looked likely to raise interest rates before the crisis broke. Mr Trichet had some explaining to do, having all but said in early August that the ECB would put rates up in September. But the uncertainty created by market turmoil gave him a good reason to wait while still stressing medium-term inflationary risks. In any case, rising interbank rates have in effect supplied the tightening that the ECB, the Bank of Canada and the Bank of England might have otherwise provided.

For the Fed, the dilemma is more acute. The weakening economy—especially a run of bad news from the housing market—made it easy for Mr Bernanke to justify a half-point cut in the fed funds rate, to 4.75%, on September 18th, even though markets had been ready to accept a quarter-point reduction. But it also makes it harder for Mr Bernanke to shake off the Fed's reputation for being quick to cut rates when markets are tumbling but slow to raise them when the economy picks up.

In 1998 turmoil in financial markets—including the collapse of Long-Term Capital Management, a hedge fund once thought too brainy to fail—helped persuade the Fed, then led by Mr Greenspan, into three quick rate cuts that contributed to the dotcom bubble. Equally, the Fed's slashing of rates in 2001-03 did much to fuel an already warming housing market.

These episodes gave rise to financial markets' belief in the “Greenspan put”—the notion that the central bank would always rescue tumbling markets. Mr Bernanke will be under great pressure to repeat the folly if investors and politicians clamour for more rate cuts. But he cannot afford to surrender the inflation-fighting credentials that his predecessors fought so hard to win.

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Error Occurred While Processing Request

Error Occurred While Processing Request

HTTP/1.1 503 Connection: close Date: Fri, 19 Oct 2007 13:30:52 GMT Server: Microsoft-IIS/6.0 X-Powered-By: ASP.NET PICS-Label: (PICS-1.0 "http://www.rsac.org/ratingsv01.html" l on "2003.01.06T14:26-0400" exp "2006.01.01T12:00-0400" r (v 0 s 0 n 0 l 0)) Content-type: text/html Expires: 0 Pragma: no-cache Cache-control: no-cache, no-store, must-revalidate

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Error Occurred While Processing Request

Error Diagnostic Information

An error occurred while attempting to establish a connection to the service.

The most likely cause of this problem is that the service is not currently running. You can use the 'Services' Control Panel to verify that the service is running and to restart it if necessary.

Windows NT error number 2 occurred.

Fast and loose

Oct 18th 2007
From The Economist print edition

Illustration by Dettmer Otto

How the Fed made the subprime bust worse

ON JANUARY 3rd 2001 Mr Greenspan had a new-year gift for America's gloomy financial markets. Outside the normal schedule of its meetings, the Federal Reserve cut the fed funds rate by half a percentage point, to 6%. But the markets' joy did not last long: the dotcom bubble had burst and the economy was already sliding into recession.

Two and a half years and another dozen cuts later, the fed funds rate was fully five percentage points lower. The Fed had seen one reason after another to ease policy. After the tumble into recession in 2001 came that September's terrorist attacks on New York and Washington, DC. By 2003 Mr Greenspan was worrying that America might be on the way to deflation, with prices falling. In June, he says in his book, “deflation was Topic A”. The Fed cut rates to 1%, the lowest since 1958, where they remained for a year.

Gradually, the Fed took up the slack, but far more slowly than it had let it out. In quarter-point steps, the fed funds rate was raised to 5.25% by June 2006. It stayed there until September's cut. Now, as America surveys the aftermath of a housing boom and the distress of those unable to make their mortgage payments, it is worth asking what part the Fed played in creating the mess it is trying to clear up. Was monetary policy too loose?

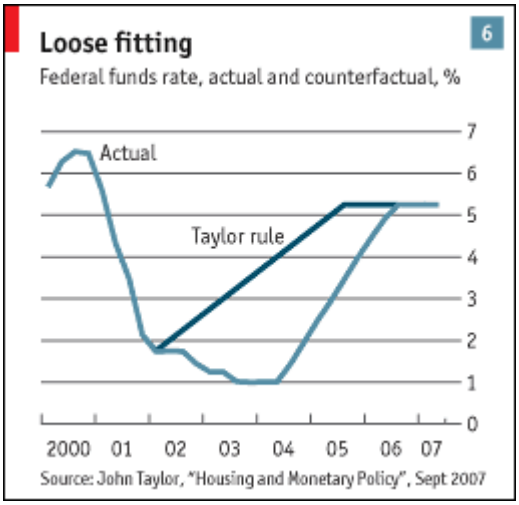
Probably the commonest way economists measure the stance of monetary policy is the Taylor rule, named after John Taylor, the Stanford University economist who invented it. The rule is a guide to what interest rates should be, depending on the amount of slack in the economy and the inflation rate.

It says that if there is no output gap (ie, if GDP is in line with the economy's capacity) and inflation is equal to the central bank's target, then interest rates should be at a neutral level, causing the economy neither to accelerate nor to slow down. If an output gap opens up, so that GDP outstrips long-run capacity, or inflation rises above target, rates should be above neutral. If there is slack in the economy or inflation dips, policy should be eased.

Of course the Taylor rule is only a rough guide. The neutral rate and the output gap, in particular, cannot be measured precisely. But the rule can tell you whether policy is roughly right or a long way out. The Fed missed by a mile.

At this year's annual central bankers' symposium in Jackson Hole, Wyoming, Mr Taylor ran his own rule over the Fed (see chart 6). Had the central bank followed it, rates in 2002 would have been going up not down. By the time rates started to rise, the gap between the actual rate and that indicated by the Taylor rule was three percentage points. The gap was finally closed only last year—long after fears of deflation had been banished. The Fed has departed from the rule at other times in the past couple of decades, said Mr Taylor, notably in the autumn of 1998, “but this was the biggest deviation, comparable to the turbulent 1970s.”

The Taylor rule is not the only gauge of monetary policy. For many central banks, the rapid rate of monetary growth has been a related source of worry. Their discomfort has been amplified by their lack of understanding of how the myriad innovations in finance affect the economy.



In Britain and the euro zone, the growth in money and credit has been in double digits. One measure at a global level is American base money plus global foreign-exchange reserves, which picks up the contribution of China's build-up of reserves. This has recently been growing by more than 10% a year, at times breaching 20%.

Economists can argue each other to a standstill over how precisely money indicates inflation. The ECB still formally rests part of its policy on the long-run correlation between broad-money growth and inflation. Many American economists are sniffy about the whole idea because money gives such a noisy signal. Long before it tells you anything, they believe, other indicators will have shown that inflation is gathering pace. Yet others, such as Mr King of the Bank of England, take a more nuanced position. In some circumstances, he believes, money and credit will give an earlier sign of inflation than other indicators do. You would be foolish to ignore it entirely.

Charles Goodhart, of the London School of Economics, and a former member of the Bank of England's Monetary Policy Committee, thinks the debate would shift if inflation were properly measured. Monetary growth is more likely to go with rapid rises in asset prices than with inflation in goods and services. “If inflation is (incorrectly) measured to exclude all asset-price inflation,” Mr Goodhart concludes, “then the links between money growth and (true) inflation may be understated.”

In any event, when the Fed started cutting rates America's housing market was already vibrant, despite the weakening of the economy as a whole. The S&P/Case-Shiller index of national home prices, the broadest measure of the American market, was rising at a rate of nearly 10% a year. Though the pace slowed in 2001, a poor year for the economy, the market was soon bounding ahead again (see chart 7).

In most markets, when prices go up, demand goes down. Housing can be different. People bought not just for the comforts that a house could offer or for the rent that it might yield, but in the expectation that prices would keep on rising. As the belief that you could not lose took hold, buying property for investment rather than for somewhere to live accounted for a rising share of the market. People even started “flipping”, buying homes still on the drawing board with borrowed money in the hope of selling again quickly at a profit.

Housebuilders responded to the surge in demand. The number of housing starts jumped from 1.5m, at an annual rate, in August 2000 to a peak of 2.3m in January 2006. In 2005 housing construction accounted for 6.2% of GDP, the highest share since 1950.

The wrong price sensitivity

Although the Fed's easing of policy helped to make housing finance cheaper, it was not the only factor. Curiously, mortgage rates stayed low even after the central bank had started to increase official rates. The immediate reason was that the price of mortgages does not depend directly on official short-term rates but on the longer-term rates at which lenders can secure funding. Longer-term rates did not rise in step with the fed funds rate: ten-year Treasury bond yields even declined at times, posing what Mr Greenspan called a “conundrum”. But that just raises another question: why did long-term rates not go up when the fed funds rate did?

One possible explanation is that markets had faith in the Fed's ability to rein in inflation in the long term,

even though policy was on the loose side. However, financial globalisation may have counted for more. America borrows from abroad on a grand scale: last year its current-account deficit soared to over 6% of GDP. And the rest of the world—especially emerging Asian economies and oil exporters—was more than happy to save and lend.

In 2005, when he was a Fed governor during Mr Greenspan's chairmanship, Mr Bernanke dubbed this a “saving glut”. Desired saving in emerging economies had gone up, he suggested, for three reasons. After the Asian crisis of 1997-98 emerging economies had become determined to accumulate foreign reserves and resist exchange-rate appreciation. Rising crude oil prices had filled oil exporters' coffers and Chinese saving rates rose even faster than investment.

This extra desired saving in emerging economies had to be accommodated somehow, because in the world as a whole saving and investment must balance. That implied lower saving relative to investment in developed countries, and lower real interest rates. In effect, oil exporters and Asian savers were pushing down American mortgage rates.

These credit-cheapening forces helped subprime borrowers to join the housing party, as did the speed with which house prices climbed. The poor by and large find it much harder to borrow than the rich because lenders are less sure about their ability to repay. But lenders look more kindly on borrowers who offer collateral, such as a house. The more valuable the collateral, the more willing they are to lend. Developments in the financial industry also made lenders more willing to extend risky credit. As prices soared and interest rates stayed low, delinquency rates remained low too. Subprime debt looked an excellent investment.

A bad time to buy

With everyone sure of a winner, standards slipped—a common failing in a craze. Some lenders did not look closely enough at their borrowers. Many borrowers had no idea of how much they might be asked to pay once interest rates picked up and their introductory teaser rates ran out.

The unravelling of all this is proving painful. Housing construction once helped drive the American economy along. Now it has been a big drag for more than a year and is likely to remain so for a while yet.

Had the Fed acted differently, would the boom and bust have been less marked? At Jackson Hole Mr Taylor said it would. He reckons that the Fed's policy explains housing starts fairly well until mid-2004, when interest rates started to rise; by then, the boom had its own momentum. Under the Taylor rule, starts would have peaked sooner—around two years earlier than happened in real life—and at a much lower level.

Mr Taylor's argument, in essence, is that the Fed fuelled the housing boom by taking its eye off inflation. Some economists, however, believe that even when inflation is low, there is a danger that asset prices will get out of hand. Low inflation could even help to set them off.

In a paper last year Claudio Borio, an economist at the Bank for International Settlements, mused on a puzzle. Despite the remarkably strong growth in monetary and credit aggregates, inflation around the world has been subdued. That could be taken as confirmation that central banks have mastered the secrets of the world economy. But Mr Borio and his colleagues at the BIS (not to mention a few central bankers) are not so sure.

He suggests that financial liberalisation, credible anti-inflationary monetary policies and globalisation have changed the way the world economy works in ways that no one quite understands. They are all good things, separately or together, but may require central bankers to refine their policies—and specifically to pay more attention to financial imbalances and the risk of asset-price bubbles.

Financial liberalisation has meant that more people have easier access to credit. This has allowed resources to be better allocated. But there are also fewer constraints on the forces that can cause booms to feed on themselves. For example, rising asset prices can generate more demand, not less. Investors see little risk when markets are near their peak. And yet, in hindsight, that is precisely when the risks of something going awry are at their greatest.

It is well known, says Mr Borio, that high inflation can disrupt economies and cause financial instability. But financial imbalances can also build up when inflation is low—as it was in America in the late 1920s or Japan in the 1980s. A technological advance, say, can set off investment booms. Awkwardly for central banks, if they have done a good job of anchoring inflation expectations at a low level, wages and prices might not rise to hold down demand. Mr Borio and Philip Lowe, now at the Reserve Bank of Australia, have called this behaviour a “paradox of credibility”. If inflation stays low, then central banks will have no need to tighten rates and hence may allow financial imbalances to build up.

Leaning machines

Meanwhile, globalisation can set off a boom, in much the same way that a technological innovation can. By pushing down inflation for a while, it may reinforce the credibility of monetary policy. If it causes inflation to dip below a central bank's target, it may even prompt a cut in interest rates, making a credit and asset-price boom more likely.

All this implies that it is not enough for central banks to focus on controlling inflation in the near term; it would also be desirable for them to lean against credit and asset-price booms that appear unsustainable, as a form of insurance against a bust further down the road. The idea has a pedigree: BIS economists, in particular, have been arguing along these lines for years, finding more sympathetic ears among central bankers than among academics.

Mr Taylor's conclusions are therefore oddly reassuring for those of orthodox mind. If over the past few years the Fed had simply stuck to its usual policy, carefully watching out for inflationary pressures, the housing boom would have been much milder. Yet this summer's turmoil has dropped asset-price worries on to central bankers' desks with a thud. What should they do about them?

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Assets and their liabilities

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Illustration by Dettmer Otto

The case for tackling asset prices—and the difficulties of pulling it off

CREDIT and asset-price booms can leave an awful lot of wreckage behind them. The casualty list after America's housing crash includes: an overhang of unsold property; a huge fall in construction; the risk of weakening consumer spending as house prices fall; a trail of bankruptcies; big write-downs among the investment banks; and the unprecedented seizing-up of some financial markets on both sides of the Atlantic.

You might conclude from this that central banks would try to stop asset prices getting out of hand in the first place. But you would be wrong. Ask a central banker what his job is—on a day when he's not busy trying to save the financial system—and he will probably say he must “maintain price stability” or “control some measure of inflation”. Decoded, that means he cares about the rate of increase in consumer prices, not the prices of houses, shares or other financial assets.

More than 20 central banks have explicit inflation targets. Others, such as the ECB, act as if they do even if technically they do not. The Fed has no formal target, but in practice it has a “comfort zone” for inflation. Mr Bernanke would doubtless like a formal goal. He praised the idea in a book he wrote a few years ago with Mr Mishkin, now on the Fed's board, and two other economists.

A central bank's target may be “core” inflation—which leaves out especially volatile prices, such as those of food or energy—or it may be “headline” inflation, which includes the bouncy stuff too. Or it may be a mixture. The Fed, for instance, concentrates on core inflation because it thinks that it predicts future headline rates better than today's headline rate does.

Asset prices, though, are not included. Housing costs do enter the Fed's calculations, via a measure called owner's equivalent rent, which makes up around 15% of the central bank's favoured measure of inflation. But the price indices targeted by the ECB and the Bank of England have no role for housing at all.

Although they do not target asset prices, central banks still have to take their effects on the economy into account. These are uncertain even by the standards of monetary policymaking. For example, a rise in house prices may make people feel wealthier. They may therefore spend more, lifting GDP and putting upward pressure on inflation. But how much wealthier? Quite a lot, if they are old folk thinking of trading down. Not at all, if they are young couples thinking of buying their first home, or a bigger one.

In a recent paper John Muellbauer, an economist at Nuffield College, Oxford, estimates how the influence of housing wealth on consumer spending in different countries may have been affected by easier credit. When credit markets are poorly developed, he reasons, increases in housing wealth are likely to reduce consumer expenditure. First-time buyers have to save more for a deposit; renters, if they expect higher

rents in future, also tighten their belts. Homeowners will not spend much more if they cannot tap the extra equity in their homes.

As credit becomes more freely available, the wealth effect turns positive. If lenders increase their maximum loans, relative to house values and borrowers' incomes, the negative effect of rising property prices on first-time buyers' spending will fall. And homeowners can borrow or refinance non-housing debts using the increased collateral value of their property. A credit crunch, by contrast, reverses both these effects.

In Britain Mr Muellbauer finds no housing-wealth effect at all before 1980, but estimates that easier credit accounts for “a substantial part” of the increase in consumption, relative to income, between 1984 and 1989. Much of the increase between 1995 and 2005 is due to a rise in the value of housing collateral. However, Britons have taken on much more debt that will eventually have to be repaid; this will weigh consumption down in the long run. Because it is hard to reduce debt quickly, he thinks consumption is vulnerable to a downturn in asset prices.

For America, his results are preliminary, but qualitatively similar: more liberal credit has increased housing-wealth effects in the United States too. There are transatlantic differences in both timing and magnitude. He estimates that every extra dollar of housing collateral now translates into six or seven cents a year of extra consumer spending, compared with only three pence in the pound in Britain.

Institutional differences may explain the gap. Mortgage interest is fully tax-deductible in America, but no longer in Britain. Americans' mortgage rates are usually fixed, whereas many Britons' are variable, so they face the risk of rising interest rates. Americans can remortgage easily when rates drop, whereas British borrowers must often pay hefty fees to get out of fixed-rate deals.

Put your foot down

Mr Bernanke and New York University's Mark Gertler developed the idea of the “financial accelerator”. When a firm borrows from a bank or from the financial markets, it will have to pay more than if it financed itself from its own resources. This is because outside lenders fear that it will exploit its inside knowledge and the cost of enforcing contracts to repay less than it should. The gap—called the external finance premium—depends on the strength of a borrower's finances. A positive shock such as an increase in productivity will boost the borrower's cashflow and balance sheet and thus cut its external finance premium. Moreover, the reduction in the premium can outlive the initial shock. Its effects on the economy, by encouraging borrowing and investment, can thus be enduring. The reverse happens if the economy suffers a negative shock.

Many other economists have since developed these ideas further. They are especially relevant just now. Recent innovations in the financial industry, such as credit databases and scoring, have made it easier for lenders to screen would-be borrowers. That seems to have encouraged lending, especially to subprime borrowers. At the same time, ever more layers of securitisation have separated the original lender or broker of a loan from the ultimate bearer of credit risk. That may have impaired the ability of banks to screen borrowers, enhancing the strength of the accelerator and thus amplifying any downturn in the economy.

If you apply the financial accelerator to households rather than firms, it is clear that rising house prices reduced homeowners' borrowing costs by boosting the amount of equity in their homes. As Mr Bernanke remarked in a speech a few months ago, this suggests that changes in property prices should affect consumer spending by more than conventional wealth effects imply. Presumably, that will happen when the housing market is on the way down as well as up.

That adds to the struggle monetary policy faces in coping with asset-price booms and busts. Of course, central banks know about the difficulties that surging and plunging asset prices can cause. The question is whether they can stop asset markets going wild in the hope of averting trouble later, or must wait for a crash and then deal with any macroeconomic effects.

Some economists think that central banks should be prepared to “lean against the wind” if asset prices are rising fast. Raising rates when markets are beginning to look effervescent could forestall the disruption that a bubble and subsequent burst would bring. Most, however, say that central banks should leave asset prices be. Mr Bernanke wrote another paper with Mr Gertler arguing that central banks would do better not to try to stabilise asset prices but instead to concentrate on a target for consumer-price

inflation.

Mr Woodford, of Columbia University, believes that monetary policy should focus on core inflation, because this makes it easier to avoid distortions in relative prices. In the event that relative prices have to adjust, forcing flexible prices to move causes no great distortion, because they adjust easily. Forcing “sticky” prices to move, on the other hand, can cause large distortions. Since the prices of commodities and financial assets are among the most flexible, policymakers should let them vary and should stabilise stickier prices instead. For these reasons, Mr Woodford thinks central banks should target core inflation rather than a broader measure.

The Fed's preference has been to deal with the after-effects of asset-price bubbles rather than to try to prevent their formation. Mr Greenspan did once warn financial markets against “irrational exuberance”, in December 1996, when the stockmarket was soaring. The market was jolted briefly, then carried on up.

A few months later Mr Greenspan tried again, this time with a rate rise. According to Mr Greenspan's recent book, at the Fed's rate-setting committee meeting in February 1997 “we agreed that trying to avoid a bubble was consistent with our mission, and that it was our duty to take the chance.” In March the Fed put up rates by a quarter of a point, citing worries about inflation (and making no mention of share prices). The Dow Jones slipped by 7% a few weeks later, but roared on again afterwards. Mr Greenspan stopped trying to fight the market: “We looked for other ways to deal with the risk of a bubble. But we did not raise rates any further, and we never tried to rein in stock prices again.”

Mr Mishkin returned to the theme at Jackson Hole last month, echoing Mr Greenspan's eventual line. He argued that pre-emptive bubble-pricking rested on three assumptions, none of them likely to be met. First, the central bank must be able to identify a bubble in the making. But that implies that the central bank knows better than the market. It doesn't, said Mr Mishkin; if it knows for certain that a bubble has developed, then so will the market and the bubble will pop anyway.

Second, monetary policy must be unable to deal with the consequences of a burst bubble. The experience of Japan in the 1990s is often cited as evidence that it cannot. But, said Mr Mishkin, Japan's policymakers made a lot of mistakes: the imbalances in its banking industry were not sorted out, so they got worse. And the Bank of Japan did not ease policy enough once the bubble had burst.

Third, central banks must know the right monetary policy to deflate a bubble. That seems improbable too. By definition, bubbles are events during which people do not behave normally. The effects of an interest-rate rise in such times would be unusually hard to predict. It might even do more harm than good.

Better, said Mr Mishkin, to act fast once a bubble bursts. He set out what might happen if American house prices fell by a massive 20% in 2007-08, assuming that an extra dollar of housing wealth changed consumer spending by 3.8 cents (as in the Fed's own model). If the Fed stuck to the Taylor rule, and waited for output to weaken before cutting interest rates, after three years GDP would be 0.5% lower than it would have been without the housing collapse. With a housing-wealth effect twice as large (the same size as in Mr Muellbauer's study) and one and a half times as speedy, it would be 1.5% lower a little earlier.

If monetary policymakers chose an “optimal” policy and cut rates once house prices started to decline, without waiting for output to sag, the maximum fall in GDP would be only 0.25% in the basic model and 0.5% in the version with bigger housing-wealth effects. His calculations seem to have been more than an academic exercise. The Fed cut rates by half a point a couple of weeks after Mr Mishkin presented his paper, saying that it hoped to “forestall some of the adverse effects” of the financial-market fallout.

Whether Mr Mishkin is right to be so optimistic about what policy can do once bubbles have burst remains to be seen. As he admits, making policy when house prices are declining is harder than his model makes it look. And despite his pessimism about what can be done when bubbles are forming, he notes that some central banks see things differently, even if they do not explicitly lean against the wind. Officials at the Bank of England and the ECB have suggested that shifts in asset prices might justify extending the period over which they intend to bring inflation into line with their objectives.

However, the most interesting idea may lie within the Bank of Japan's policy framework, adopted last year. Given Japan's recent history of bubble and slump, the way this framework is used may be worth watching.

The BoJ looks at monetary policy from two “perspectives”, given the inflation rate that the members of its Policy Board thinks consistent with that goal. All nine of them put this rate between zero and 2%, with most around 1%. The first perspective is fairly standard stuff: the outlook for economic activity and prices over the next couple of years, assuming that rates move in line with market expectations.

The second involves a longer view. It assesses “the risks considered most relevant to the conduct of monetary policy”, taking into account the costs should disaster strike, slight as the chance may be. As an example of this sort of calamity, the BoJ's publications cite the risk that the expectation of a long period of low interest rates will cause firms and banks to overreach themselves. The memory of Japan's post-bubble decade is still fresh.

Since last summer Japan has raised interest rates twice, from zero to 0.5%. Further rises had been expected, but have been put on hold for the moment, following the subprime turmoil and signs that the economy was slowing. So far the BoJ has explained these increases in terms of the first perspective alone, but one day the second perspective may have to be called in aid. Whether that succeeds in heading off the next Japanese bubble will be an experiment to which the BoJ may not be looking forward.

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On credit watch

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Illustration by Dettmer Otto

Financial supervision has been found wanting. But it needs an update, not an overhaul

IMAGINE a country where a fifth of all mortgages are taken out by the shakiest borrowers. About half those loans are written by companies that are almost entirely unregulated. The mortgages, on average, are worth almost 95% of the underlying house. Half of them demand no documentation of the borrower's income.

These loans are then bundled and sliced into complicated debt instruments. The risk of these is gauged by credit-rating agencies which are paid by the very firms that created the securities and which make a lot of their money from advising on how to win the best ratings. Many of these structured debt instruments are bought by banks in other countries using off-balance-sheet entities for which they make little capital provision and about which banking supervisors know virtually nothing.

Financial supervisors tend to be sober and calm, but that tale ought to bring any half-competent regulator out in a cold sweat. It is only a sketch of the chain that led from America's subprime mortgage market to Europe's banks—the faultline of this summer's turmoil. But it shows that central banks need to draw lessons from the mess that go well beyond monetary policy. Inadequate financial supervision—whether of America's mortgage companies, Germany's bank “conduits” or Britain's Northern Rock—played as much of a role in spawning this crisis as did excessively low interest rates.

Banks have long been among the most highly regulated and tightly supervised private institutions. That regulation is the price paid for the public sector's promise to step in if banks are hit by a sudden panic or if the financial system's stability is threatened. Because of the mismatch between their assets (long-term loans) and their liabilities (deposits to which people have instant access), banks are inherently fragile creatures, acutely vulnerable if depositors suddenly take fright.

Bank failures, in turn, can have dire economic consequences. A shortage of cash can freeze the payments system, causing runs on otherwise solvent banks and bankrupting businesses that suddenly find themselves unable to raise funds. To reduce these dangers, modern central banks promise to act as lenders of last resort and governments try to reduce the chances of a bank run by providing some form of insurance to depositors. In return, banks are watched over by supervisors to ensure they do not take excessive risks.

Illustration by Dettmer Otto

But in recent years the nature of bank supervision has changed much less than the business of banking has. Bank supervisors have been most concerned about banks' capital: they want to make sure banks have enough set aside to cover losses from defaults on their loans. Since 1988 the world has had a set of internationally recognised standards for the minimum amounts of capital that banks should hold. These standards are often known as Basel 1, after the Swiss city where the international central bankers' group, the Bank for International Settlements, has its headquarters.

The problem is that Basel 1's rules predated the boom in securitisation. Thanks to technological wizardry, globalisation and the incentives created by Basel 1 itself, banks have moved away from holding loans on their books. Instead, they package them as tradable securities and sell them on. A dizzying array of mortgages, credit-card receivables and corporate loans are shifted off bank balance sheets in this way. Banks are now in the moving business, not the storing business.

In some ways securitisation has made the financial system safer. The losses from a default are now dispersed among countless investors. But the events of this summer have shown that risks remain, and that Basel 1 is not equipped to deal with them. In particular, the rules give banks an incentive to sell on their least risky securitised assets while keeping the riskiest ones (since both have the same capital charge, but the riskiest ones earn more). They also encourage off-balance-sheet entities, such as conduits or structured-investment vehicles, because Basel 1 allows banks to set aside less capital for these semi-detached concoctions than for assets on their books. German banks, for instance, did not have to make any capital provision for short-term lines of credit to conduits.

Bank supervisors have long been aware of these inadequacies. More than a decade ago they began discussing an updated set of rules for assessing capital adequacy, and agreed on them in 2004. This new accord, known as Basel 2, improves on some of its forerunner's shortcomings. For instance, it analyses the risks in securitised assets more finely and gets banks to set aside more capital for contingent liabilities. But Basel 2 is not yet in place. A few European banks have adopted the rules. More are set to follow next year. A handful of American banks will implement them in 2009.

The worries about Basel 2 go beyond the slow pace of implementation. The new rules rely heavily on credit ratings to signal which securitised assets are riskiest. Unfortunately, this summer's mortgage mess showed that credit ratings are a flimsy prop. The rating agencies suffer from skewed incentives. They have been growing fat on the profits from helping banks create complex debt products. The profits of Moody's, one of the three main credit-rating agencies, more than doubled between 2002 and 2006. When business is that good, who would want to stop the party by warning investors about the risks from fancy new securities?

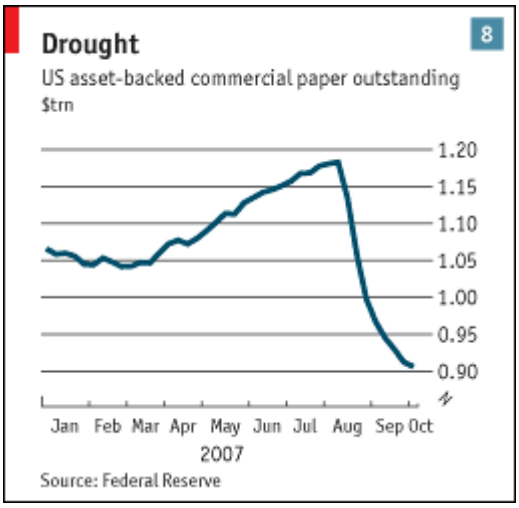
So the supervisors face a double whammy. This summer's upheaval showed the inadequacies of their old capital rules while raising questions about their new ones. But it also showed the limits of relying on capital adequacy as a gauge of banks' resilience.

The wrong sort of protection

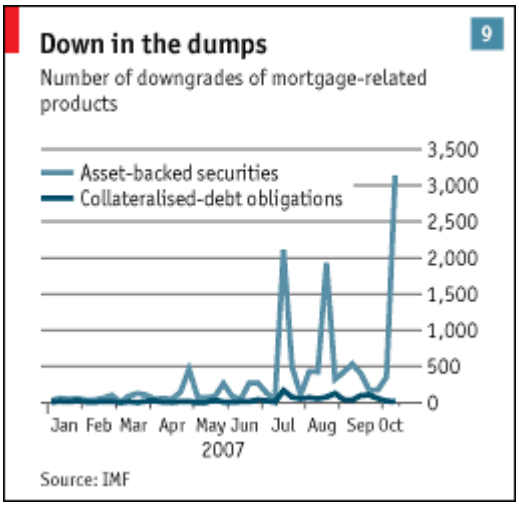
Capital-adequacy rules are designed to protect a bank from insolvency. But during the summer, the

volume of defaulting subprime mortgages was trivial compared with the banks' capital. The main problem was not insolvency; it was illiquidity.

Spooked by rising losses on subprime assets, investors lost confidence in rating agencies. Unable to assess credit risk in complicated structured products, they refused to buy any type of mortgage-backed security. A vast and supposedly liquid market suddenly dried up (see chart 8). As a result, financial institutions that relied on this market for their financing fell on hard times. Northern Rock used short-term funding for around 65% of its mortgages. Conduits were issuing short-term paper, with an average maturity of 45 days, to buy collateralised-debt products with a maturity of several years. Both exposed a familiar fragility—the mismatch between long-term assets and short-term liabilities—but in a market that had barely existed a decade earlier. As mortgage-related products were downgraded (see chart 9), this illiquidity spread further and banks became reluctant to lend to each other. This sent interbank rates soaring and forced central banks to step in.



They reacted in different ways and with varying degrees of success to the sudden liquidity dearth (see article). Central banks have lessons to learn about what it means to be a modern lender of last resort. But policymakers also need to rethink financial supervision. Today's rules have been found wanting. How should they be improved? To answer that question, you need to look at who does the regulating, what is regulated, and how.



Financial supervision takes many forms. In some places (notably Britain), supervision is wholly separated from the central bank. After the Bank of England became independent in 1997, responsibility for the oversight of all kinds of financial institutions—from stockmarkets to insurance firms—shifted to a new super-regulator, the Financial Services Authority (FSA). In America the Fed has supervisory authority over the holding companies that own banks as well as some state-chartered ones, but it shares responsibility for banking oversight with a plethora of other institutions, such as the Office of Thrift Supervision, the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Securities and Exchange Commission and many state regulators. Within the euro zone, the European Central Bank provides liquidity to the market, but all supervisory responsibility rests with national authorities. In some countries, eg, the Netherlands, the national central bank doubles as a broad financial regulator. In others, eg, Germany, supervision is split.

Until recently, the structure of supervision was a sideshow. The few wonks who cared reckoned that every approach brought advantages and drawbacks. Removing supervisory authority from central banks reduced the risk that central bankers would compromise their inflation-fighting mandates by, say, keeping interest rates low to shore up weak banks. At the same time central banks, such as the Fed, have long argued that their supervisory role helps them promote financial stability. The woolly consensus was that it was important to get international agreement on the rules and let countries implement them as they wished.

The first lesson of 2007 is that these divisions of labour are not simply academic. The Northern Rock fiasco has cast doubt on Britain's system of separating the lender of last resort from nearly all aspects of supervision. To be sure, the mess had a lot to do with shortcomings within the separate organisations. The FSA, once heralded as a model super-regulator, has egg on its face for failing to do anything about Northern Rock's risky funding strategy. But it also seems clear that central banks, as the ultimate providers of liquidity, need to be more aware of what banks are up to.

The Fed's more consolidated approach made crisis management easier. But America, too, has lessons to learn. Its fragmented system of financial supervision has large loopholes and leaves plenty of room for financial firms to shop around for the weakest rules. Subprime-mortgage firms took full advantage. The central bank and the other federal banking regulators oversee only deposit-taking institutions. But around half of all subprime loans had nothing to do with traditional banks: they were written by state-chartered mortgage companies. Some states had exacting supervisory standards for these firms. Others,

such as California, paid much less attention. Not surprisingly, the laxest mortgage-lending practices took place in those states. One estimate suggests that 70% of new homes in California last year were bought using low- or no-doc loans.

Everyone agrees that the oversight of subprime-mortgage lending was inadequate. So far, however, most of the lessons being drawn focus on consumer protection. Politicians are keen to draw up new rules to ensure that mortgage companies do not mislead or mistreat naive borrowers. There, too, the fragmented system poses problems. The Fed is charged with writing rules on consumer protection that apply to all financial institutions, but it has no legal authority to enforce those rules in organisations it does not oversee. The regulators are making more effort to co-operate. Federal and state banking regulators announced in July that they would look at a sample of non-depository mortgage firms when they carry out their checks on consumer-lending standards.

Illustration by Dettmer Otto

The more important question raised by the subprime mess, however, has to do with financial stability rather than consumer protection. At one level, the case for more intrusive prudential supervision seems weak. The implicit bargain that underlies bank supervision—regulation in exchange for deposit insurance and back-up from the central bank as lender of last resort—does not strictly apply to institutions without any depositors. Regulation inevitably has a cost, inhibiting the kind of innovation that brought clear benefits. America's overall rate of homeownership has risen from 64% to 69% since the mid-1990s; among blacks it has gone from 42% to 48%. What is more, the subprime market is adjusting rapidly to the recent excesses: scores of the weakest lenders have gone bust.

On the other hand, the securitisation of subprime mortgages turned out this summer to be merely the first link in a chain of skewed incentives that left the overall financial system acutely vulnerable. Investors were clamouring for mortgage-backed securities. This meant that originators—who retain little or no risk—had scant cause to probe deeply into borrowers' creditworthiness. That failure reverberated up the chain as default rates soared, and ended with the central bank's large provision of liquidity. So for supervisors charged with financial stability, those skewed incentives pose problems.

Remedies for regulators

One way to address them would be to shift originators' and securitisers' incentives by fiat. If these firms were obliged to retain some of the riskiest tranches of securitised assets on their books, they might be more careful about lending standards. That is a good idea in theory, but hard in practice. Agreeing on such rules in America's fragmented supervisory system would be a nightmare. Nor would they necessarily be effective, since firms could hedge against their risky exposures with derivatives. Moreover, undifferentiated rules would create inefficiencies. The share of risky equity appropriate for a huge national firm is surely different from that for a small local lender.

Another approach would be to correct the distorted incentives one step further up the financial food chain—with the rating agencies. After all, if rating agencies are doing their job properly, they should discourage lax lending standards by originators of mortgages and all manner of other securitised assets.

Policymakers on both sides of the Atlantic have rating agencies in their sights. In America the President's Working Group on Financial Markets, which includes the Fed and the Treasury, has begun a probe into them. In Europe securities regulators are preparing a report of their own.

No one doubts that agencies such as Standard & Poor's, Moody's and Fitch are a weak link in the securitisation model. But opinions differ on why. Is it thanks to their inherent conflicts, to their failure to understand the complex instruments they are rating or, perhaps, to investors' confusion, wilful or otherwise, about what ratings are supposed to reveal? The agencies plead that they have been misused and misunderstood. They point out that their ratings measure credit risk—ie, the odds of default on a debt instrument that is held to maturity. But they measure neither market risk (whether the price of the asset will rise or fall until it reaches maturity) nor liquidity risk (whether the asset will remain easily tradable). Investors were wrong to assume that all AAA-rated instruments would be equally liquid.

If this is right, then greater transparency would be the best antidote. Since the crisis, the rating agencies have been busy peddling tools that assess liquidity risk. In effect, this could differentiate between an AAA-rated structured-debt product and a trusty old AAA corporate bond.

However, many people think that the rating agencies' problems are more fundamental than that. Some investors, such as public pension funds, are restricted in the types of securities they may own. In effect, that makes the rating agencies part of the regulatory machinery—a position that is reinforced by Basel 2. Citing their rights to free speech, the agencies have also successfully fought off legal challenges to ratings that turned out to be misleading.

Most important, the agencies are paid by the issuers whose securities they rate. This last conflict has proved unavoidable. Ratings are valuable only if everybody knows them, but investors have no reason to pay for information that is available to everyone else too.

Those inclined to intervention see the need for wholesale change. Particularly in Europe, they want government regulation or even public funding for rating agencies. That has big drawbacks. Moving rating agencies into the public sector would surely stifle innovation. And government-funded ratings could come dangerously close to being public guarantees. Investors would demand bail-outs for any losses if they went wrong.

Rather than pushing radical change within rating agencies, financial supervisors may do better to rethink their role in the regulatory machinery. In particular, that may mean looking again at bits of the Basel 2 accord. The new rules offer banks two main methods for assessing their capital adequacy. Sophisticated banks can use their own internal risk-management systems; smaller banks can use a “standardised” method, which relies on calculating risks on the basis of credit ratings. The rating agencies' shortcomings suggest that, even for smaller banks, that reliance ought not to be mechanistic.

In addition, financial markets are creating alternative ways of gauging default risk, through the price of credit-default swaps, for instance. As those markets gain in sophistication, regulators should avoid locking in a perverse reliance on rating agencies.

Overall, though, Basel 2 is an improvement on Basel 1. The rules cover a broader range of risks, align capital more tightly with the amount of risk, reward institutions with more sophisticated risk-management systems and demand both more stress-testing and greater transparency. Such things might have prevented some of this summer's problems—particularly the parking of debt in shaky conduits.

But Basel 2 is still only a set of standards for banks' capital. The rules have little to say about stress-testing liquidity. Should the supervisors now draw up rules to do that too?

There are some informal guidelines on good liquidity management but no international standards. Mr King argued on October 9th that “regulation worldwide has paid insufficient attention to liquidity, focusing instead on capital.” He pointed out that differences in liquidity management are huge. Countrywide, an American mortgage lender, paid millions of dollars to secure lines of credit from big banks and drew on these when the asset-backed market seized up. By contrast, Northern Rock had made no such provision.

Mr King is right that regulators need to think harder about banks' liquidity. The Basel committee is already doing so. But it is not a matter of simply drawing up new rules. Supervisors' experience with the Basel capital requirements suggests that the pace of regulatory change is glacial and that banks will innovate around new rules they find burdensome.

All told, supervisors should be humbled by the past few months, not emboldened. They, along with many others, failed to foresee the risks. The Fed cheered on the subprime boom. The FSA had not looked carefully at Northern Rock for 18 months. Misconceived regulations, particularly over the off-balance-

sheet vehicles, have created some of the problems. There are lessons to be learnt and adjustments to be made in the machinery of financial supervision. But it is a question of tinkering, not wholesale change.

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Smash the glass

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The last resort for liquidity

THE chief executive of a large American bank once approached Paul Volcker, then chairman of the Fed, to ask him how he would respond if the banker were to seek a bail-out. Mr Volcker replied that he would be glad to discuss the request with his successor. The story is apocryphal, but it captures the tough love expected from central bankers as lenders of last resort.

Central banks must demand a price for lending when others will not. But they must not be too severe. When demand for liquidity spiked in early August, it was akin to a run on the whole banking system. Banks suddenly had to provide credit to entities that had previously relied on the commercial-paper market for funding. This strained their liquid resources, in much the same way as a long queue of depositors would have done. As pressures rose, interbank lending dried up and central banks felt they had to step in and lend freely.

A lender of last resort provides liquidity in a crisis to banks (and to the market as a whole) when there is no alternative. This summer the way that each central bank operates in normal times determined how it was able to act in the crisis. Central-bank lending is secured: borrowers must provide collateral, as well as interest, in return for cash. One reason the ECB could lend liberally was because it accepts a wide range of collateral, including corporate and asset-backed bonds.

Offering less pukka security is not costless. As a rule, the riskier the bond and the further it is from its redemption date, the lower the value of the loan that can be secured on it. But accepting a wide spectrum of collateral helps in a crisis when banks are reluctant to surrender their liquid assets. The ECB regularly supplies 90-day loans to the money markets too. When funding at that maturity was in short supply, it arranged extra auctions, at which demand was heavy.

The Fed has less freedom. By law it can accept only government debt or its closest equivalents as collateral when it supplies cash to the money markets. However, the Fed can bypass the markets and lend directly to banks at its discount window, where collateral standards are more flexible. To ensure that the facility is used only in an emergency, the charge the Fed makes for such lending is usually one percentage point above the money-market rate it targets in its daily operations. In a crafty move, the Fed cut the excess charge by half in mid-August and stage-managed borrowing by some obviously solvent banks to lessen the stigma of using the discount facility. It also offered loans for up to 30 days to try to free up the markets for longer-term financing.

The ECB's and the Fed's flexible responses to the crisis contrast with the rigidity of the Bank of England's liquidity regime. Initially the bank declined to offer the extra liquidity provided by other central banks. Instead it relied on the sterling money market to right itself. After all, the liquidity hoarding would not last for ever. In the meantime, a bank that found itself temporarily short of cash could use the central bank's standing lending facility (which accepted only first-class collateral), with a 1% penalty over policy rates.

This severity was a deliberate policy from the top. The bank's governor, Mr King, fended off calls to relax collateral terms or to provide longer-term financing. But when Northern Rock, an apparently solvent mortgage bank, applied for lender-of-last-resort support, it forced a U-turn.

This debacle suggests the Bank of England's regime was too strict in a crisis. But a lender so reliant on money-market funding would probably have struggled anywhere. Still, crises should be met with liberality. A punitive stance increases the stigma of being short of liquidity and encourages banks to hoard cash, making the crisis worse. Better to encourage banks to hold enough liquidity before the crisis hits than to punish them after the event.

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Amid the gloom

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Illustration by Dettmer Otto

The credit crunch has cast a cloud over the world economy. Thank goodness it started out so strong

IN ECONOMIC terms, the first few years of the 21st century have been a roaring success. Between 2003 and 2006, global GDP at market exchange rates grew by 3.5% a year. At purchasing-power parities, according to the IMF, it surged ahead at just under 5% a year. That is its best run for more than three decades.

The great fear is that this locomotive is about to slow in the rich economies, and that this slowdown will be passed on to emerging markets. In America growth is already fading. In Britain and the euro zone it may also be scaled down, partly by weakening exports and partly by tighter credit conditions. Japan's economy has stuttered all on its own.

The great hope is that the fast-growing emerging economies, notably China, are strong enough to come to the rescue. This year for the first time China alone will contribute more to global GDP growth than America, even if the American economy does not slow. In the first half of this year overall American growth contributed less to world GDP growth than did the increase in Indian and Chinese consumer spending, measured at market exchange rates.

That Asian resilience is about to be tested. After a good second quarter in America, with GDP growing at an annualised 3.8%, the news in the third quarter has been gloomier. Its housing market has gone from bad to worse, with slow sales of existing homes and falling prices. Housebuilders and lenders are eaten up by gloom. By this August the number of new homes started had fallen to 1.3m at an annual rate, 42% below the peak. New-home sales in August were 8.3% lower than in July and a vertiginous 21% down on a year before. Builders have slashed prices to get new properties off their hands—the median price fell by 7.5% in the year to August. But they still had more than eight months-worth of sales on their books.

Weak construction activity has been dragging down the economy for a year or more and will keep doing so for a while yet. On top of that, weak house prices will hurt consumer spending. As Mr Mishkin made clear at Jackson Hole, estimating by how much is an inexact business, even if you knew how far house prices would drop, which no one does. This week the IMF cut its July forecast of growth in 2008 by almost a full percentage point, to 1.9%. The Fed's half-point cut in mid-September showed that the central bank is worried about the effect of the housing market on growth—but also that it hopes speedy action will limit the extent to which that infects the broader economy.

Until the credit squeeze, Europeans could afford to take a relaxed view of an American slowdown. The direct effects of the housing downturn would have been confined to the United States, and the possible knock-on effects on trade did not look so bad. Exports to America account for only 2-3% of the euro zone's GDP. Euro-zone exports to Asia, central and eastern Europe and oil-exporting countries have been growing apace.

The threat now is that the malaise in the credit and currency markets will worsen and be transmitted from the new world to the old. Granted, the European economy still looks strong—German unemployment fell to a 14-year low last month—but the credit upheaval has clouded Europe's prospects, prompting the IMF to cut its forecast of euro-zone growth next year by 0.4 percentage points, to 2.1%.

The Fed's rate cut—and the prospect of more to come—have sent the dollar tumbling to below $1.40 to the euro, the lowest since the single currency was born in 1999. For America, that may be no bad thing. A weaker dollar will rebalance America's economy towards exports and away from consumption, and dent its huge current-account deficit. But a stronger euro will not help the euro zone's exports.

Worse, worries about the exposure of some of Europe's banks to American subprime-mortgage debt continue to infect European interest rates. Money-market rates in America seem to be settling down, helped by the Fed's rate cut. European banks, however, were still reluctant to lend to one another.

That, plus the rising euro, should have much the same effect on the euro zone as an increase in official interest rates, which helps to explain the postponement of an expected rate rise by the ECB. In Britain, too, money-market rates have been high and the Bank of England's first credit-conditions index, published late last month, suggested some tightening. Those countries where house prices have climbed most—Britain, Ireland and Spain—look most vulnerable.

Politicians, banks and businesses are urging the central banks in Britain and the euro zone to keep growth going by cutting interest rates. But the bankers should not be in too much of a hurry.

One reason is that China is more robust than many think—and correspondingly less vulnerable to a slowing rich world. Its inflation rate is high, which some fear could yet cause a hard landing for its economy. Others point to the fragility of its overvalued stockmarket. Yet inflation is high because of food prices, rather than because of overheating, and therefore cannot be cured by a rate hike. Similarly, the Chinese economy is relatively immune to changes in the value of shares. China exports a lot, yet domestic demand will still account for three-quarters of its growth this year. Even without the stiff breeze of exports at its back, China's economy would still advance by 9%.

A second reason not to rush into rate cuts is that the credit squeeze, if not the liquidity crisis, is in some ways necessary. Over the past few years risks of many kinds had been underpriced. Some repricing has already gone on: the spreads between low-grade and high-grade corporate debt have widened; and mortgage lenders are distinguishing more carefully between different kinds of borrowers. There is more still to do, unravelling devilishly complicated packages of debt and derivatives. Easing policy quickly could smooth this, but it could distort it too.

Central banks have to remember that the subprime slump and the squeeze it has triggered have happened partly because monetary policy has been too loose in the past. This has allowed them to enjoy years of rapid economic growth. The credit crunch is a warning that such things always catch up with you in the end.

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Expect a lot...

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...but not miracles

Illustration by Dettmer Otto

THE past 20 years have spanned central banking's golden age. Out of the ruins of the 1970s inflation and after a hard-fought decade repairing the damage in the 1980s, a handful of people laid down the foundations for prosperity. In an era when state planning fell into disrepute, here was one lot of technocrats who actually knew what they were talking about.

So it may seem churlish to dwell on what has gone wrong. But this summer's credit crunch foreshadowed difficulties central banks will continue to face. Some of these are the eternal dilemmas that central bankers are doomed to relive time and again. If action in a crisis saves the innocent but also rewards foolishness, how should they strike the balance? Some are the problems of success. How do you ward off asset-price insanity when inflation expectations are low and the appetite for risk has grown too much? And some of the riddles are new. How do you safeguard the financial system from extravagance that rapidly spreads from the fringes of financial innovation to the centre?

Perhaps this summer's most troubling lesson, however, was not economic or supervisory but political. As people have grown accustomed to the benign economic conditions that central banks have helped to create, they have forgotten just how hard-won the victory over inflation was. Just suppose another fight were needed: would the world have the stomach for it?

During the credit crunch Mr Bernanke at the Fed came under huge political pressure to cut interest rates. Mr King at the Bank of England found it impossible to stick to his stern rule about providing liquidity to the interbank market. Mr Trichet at the ECB received a haranguing at the hands of Nicolas Sarkozy, his compatriot and the president of France. And this was not even a recession. In his recent book, Mr Greenspan said he was worried that the central banks would be unable to withstand the political pressure to inflate if the temporary cost of steadfastness in jobs and lost output was high.

Politicians will always lean on central bankers—that is the argument for central-bank independence. The irony today is that their arguments are bolstered by people's unrealistic expectations of central banks' powers. Mr Greenspan set the precedent when he saw off the worst of recession in spite of dotcom busts and terrorism. Central banks are powerful institutions. No wonder people expect them to step in when they need help.

Central bankers have never had any illusions of their own omnipotence. Theirs is an imperfect science and there are disagreements about what to target and how. Moreover, central banks make mistakes, as the Fed did in allowing the housing bubble to inflate. The extraordinary pace of financial innovation and globalisation has been a nagging source of self-doubt.

Knowing how hard it is to get things right, central bankers find their reputations for proficiency invaluable. In normal times, a reputation helps to anchor low inflation. If policy turns out to be slightly too loose, prices are less likely to take off. That is good for the economy's stability. The trouble is that in crises, central bankers' reputations feed the demand for action, whatever their formal independence is supposed to guarantee. And that may lead to too much intervention too soon.

The hope in the financial markets is that the worst of the credit crisis is now past. This optimism may be justified. But things are still far from normal. Even as share prices keep rising, the credit markets struggle to get deals away. Although spreads have narrowed, they remain stretched. Fix bankers with a hard stare and their swagger soon fades.

That suggests the financial and economic ramifications of a remarkable summer have still to work through. If the real economy slows by much, it will feed back into the financial sector and the screw will tighten once more. Central bankers must already be looking back on recent sunny uplands with a touch of nostalgia. After all, they are only human.

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Internet companies

Social graph-iti

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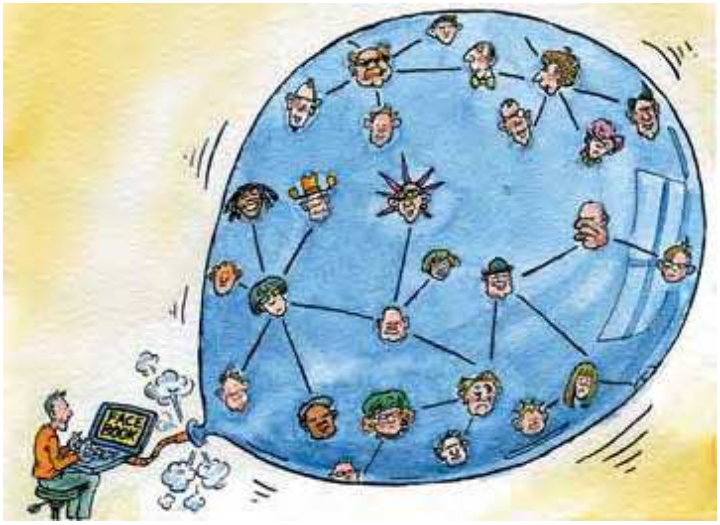
Illustration by David Simonds



There's less to Facebook and other social networks than meets the eye

A NEW fad is sweeping across Silicon Valley, causing excitement, confusion and hyperbole not seen since the dotcom bubble. It began in May, when Mark Zuckerberg, ten days after turning 23, took the stage in a San Francisco warehouse and announced that he was opening up Facebook, the social network he founded at Harvard University, to outside programmers. Anyone can now build little programs, or "widgets", into the network. To illustrate his idea, Mr Zuckerberg projected onto the wall behind him a "social graph"—a pattern of nodes representing Facebook users and the links among them.

Since then Facebook and the idea of the social graph have become the favourite, if not the only, topic of conversation among the valley's geeks, venture capitalists and internet moguls. Mr Zuckerberg compares his graphing of human connections to the work of Renaissance mapmakers. Facebook is growing furiously and may catch up with MySpace, the biggest social network. Outside programmers have added about 5,000 widgets.

One of Facebook's investors estimates the social network's revenues in 2007 at only $100m, mostly from selling ad space, with tiny profits. Nevertheless, the internet's giants—Yahoo!, Microsoft and Google—are offering to buy Facebook or a stake in it for a price that would value the firm at many billions. At a Facebook conference on "Graphing social patterns," panellists said the firm may be worth $100 billion and that it is the new Google.

How much of this is hype? Facebook has made two genuine breakthroughs. The first was its decision to let outsiders write programs and keep all the advertising revenues these might earn. This has led to all kinds of widgets, from the useful (comparing Facebookers' music and film tastes, say) to the inane (biting each other to become virtual zombies). The entire internet industry reckons this was clever and is planning to copy it. This week MySpace said it would open its site to outside programmers. Google, which owns Orkut, a social network extremely popular in Brazil and parts of Asia, is expected to do the same soon. Facebook's second masterstroke is its "mini-feed", an event stream on user pages that keeps users abreast of what their friends are doing—uploading photos, adding a widget and so on. For many users, this is addictive and is the main reason they log on so often. Jerry Michalski, a consultant, calls the mini-feed a "data exhaust" that gives Facebook users "better peripheral vision" into the lives of people they know only casually. This mini-feed is so far the clearest example of using the social graph in a concrete way.

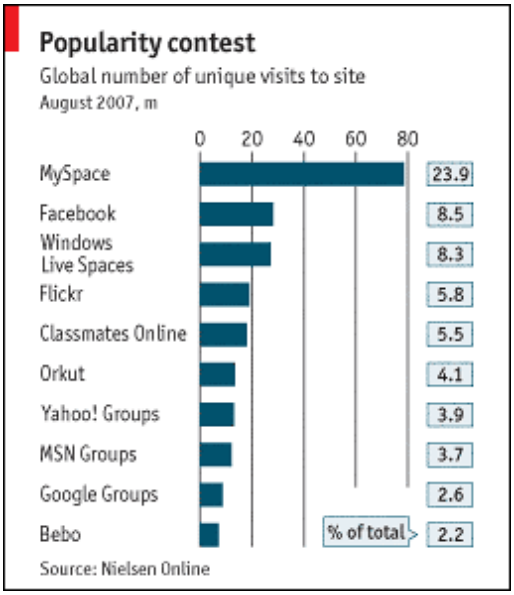
Silicon Valley's craze for the "social graph", however, is overdone. The term has been around in computer

science for decades, says Eric Schmidt, Google's chief executive, so it is puzzling that Mr Zuckerberg should get any special credit for using it. “We have address books, and the sum of the address books is the social graph,” he says. Companies such as Plaxo, which help to synchronise address books, and Google itself, which has a primitive address book in its web-mail service, plan to turn these books into fully fledged social graphs that can do useful and productive things, perhaps including new variants of mini-feeds.

This analogy to address books points to an important limitation for social networks, such as Facebook, compared with older sorts of network, such as the postal or telephone systems. These benefit from Metcalfe's Law, which says that the value of a network is proportional to the square of the number of its users. In other words, the more people have phones, the more useful they become. This “network effect” leads to rapid adoption and puts up barriers for new entrants.

But unlike other networks, social networks lose value once they go beyond a certain size. “The value of a social network is defined not only by who's on it, but by who's excluded,” says Paul Saffo, a Silicon Valley forecaster. Despite their name, therefore, they do not benefit from the network effect. Already, social networks such as “aSmallWorld”, an exclusive site for the rich and famous, are proliferating. Such networks recognise that people want to hobnob with a chosen few, not to be spammed by random friend-requests.

This suggests that the future of social networking will not be one big social graph but instead myriad small communities on the internet to replicate the millions that exist offline. No single company, therefore, can capture the social graph. Ning, a fast-growing company with offices directly across the street from Facebook in Palo Alto, is built around this idea. It lets users build their own social networks for each circle of friends.



So are Facebook and its graph really worth many billions? From an advertiser's point of view, says Rishad Tobaccowala, the boss of Denuo, the new-media unit of Publicis Groupe, an advertising company, Facebook is so far anything but the new Google. The search giant does have traditional network effects in its advertising system, he says: it aggregates advertisers and sends them to potential customers who have expressed specific intentions by typing search queries. But Facebook has only “large crowds who are communicating without expressing specific interests”, says Mr Tobaccowala. On Google, advertisements are valued; on Facebook they are an annoyance that users ignore.

Facebook might nonetheless be suited for other sorts of marketing. Reuben Steiger, the founder of Millions of Us, a marketing agency for social networks and virtual worlds, says that brands need to design “experiences” that use the social graph to engage groups of friends. If a wrestling association, say, wants to drum up ticket sales for an upcoming bout, it could build a widget that turns users into wrestlers and lets them fight bad guys and win gifts, while making them aware of the brand and the match.

But that possibility hardly justifies the sorts of valuations bandied around for Facebook and other social networks. Such valuations, indeed, may reflect a misunderstanding of the social graph. For bigger companies such as Google, the graph is simply the web of links among its many users. It can be used to make existing services more useful. But Google increasingly views such utilities as “features, not products,” says Sergey Brin, its co-founder. Facebook, like many hot start-ups in Silicon Valley, has some fantastic features, but maybe not much more.

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Russian aviation

Sukhoi's phoenix

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The Superjet 100 is carrying the hopes of a once-proud industry

MAXIM GRISHANIN is quietly confident that Sukhoi's Superjet 100 will fly from its base in Russia's far east before the year is out. Mr Grishanin, who is chief financial officer of SCAC, Sukhoi's civil-aircraft division, knows how much is riding on his country's most important commercial aviation project since the collapse of the Soviet Union. Delays of the kind that have hit Airbus and Boeing are unthinkable. “We must show the world that we are on time,” he says.

AP

Russia's cut-price jet prepares for take-off

The Superjet, a regional jet with up to 95 seats, is not only the most advanced subsonic airliner Russia has produced. It has also become a model for industrial partnership with the west. Although Sukhoi is Russia's foremost maker of warplanes, its experience of non-military aircraft is limited. And as Mr Grishanin admits, “the glory days of the Russian aviation industry are in the past.”

When, in 2001, Sukhoi began to think about producing a plane for the commercial market to offset the fall in demand for its military products, three things became clear. The first was that to compete against Boeing and Airbus in the market for big jets was not an option; the second was that if it was to make money building a smaller regional jet, it would have to sell outside Russia; the third was that to win orders in Europe and America, it would have to incorporate proven western technology.

On the advice of Boeing, which has counselled the Russians from the project's outset, SCAC concluded that although it had expertise in aerodynamics and cost advantages in airframe design and manufacture, everything else, from the avionics to the landing gear, would have to come from established suppliers. As well as reducing development time by offering SCAC “keyturn systems” that work straight out of the box, suppliers such as Thales, Messier-Dowty and Honeywell, eager to get into the Russian market, agreed to be paid a fixed amount only when each aircraft is sold. Similarly, PowerJet, a joint venture between France's Snecma and Russia's NPO Saturn to build the plane's engines, will take a share of the revenues earned by the plane over its life.

The partner with the most at stake, however, is Alenia Aeronautica, Italy's biggest aviation company. Last December, Alenia agreed to take a “25% plus one” stake in SCAC for $250m. The plus one, which is subject to government approval, gives Alenia the right under Russian law to play a part in setting the strategy of the state-controlled firm. Alenia may well be the key to the Superjet's success. With SCAC, it has set up Superjet International, a company based in Venice that will handle the marketing of the plane to Western airlines and provide the kind of after-sales support they demand.

Alenia believes that the Superjet offers big advantages over its main rivals, the Brazilian-made Embraer E-Jet and Canada's ageing Bombardier CRJ. It claims that it will not only be more comfortable for passengers, quieter and cost a tenth less to operate, but that it will also be at least 15% cheaper to buy.

As the Superjet expands into a whole family of planes with between 75 and 120 seats, Alenia reckons it will sell 800 of them by 2024—about 15% of the world's market for regional jets.

But doubts persist about the overall size of the regional-jet market, which is particularly sensitive to fuel prices. Sales have flattened out ominously after several years of strong demand. The high hopes that the Superjet will lead a revival of the Russian aviation industry will ultimately depend on convincing hard-nosed Western airlines that it is both cheap to buy and cheap to fly.

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Computer software

Programmed for a fight

Oct 18th 2007
From The Economist print edition

Oracle and SAP are battling to dominate the business-software market

APPLE versus Microsoft, Informix versus Oracle, Netscape versus Microsoft. The history of commercial software can be written as a succession of epic battles for dominance of key markets. Now the industry is in the midst of another: America's Oracle is battling against Germany's SAP in the market for enterprise applications, the software that big companies use to run their businesses.

Last week the fight got fiercer. On October 12th Oracle announced a hostile bid of $6.7 billion for BEA, which makes software to run and tie together other programmes. The bid is likely to succeed, even if it has to be raised a bit. A few days earlier SAP had said it would buy Business Objects, a Franco-American firm whose products track and analyse a firm's performance, for roughly the same sum.

Both companies need to find new pastures to grow. Oracle first tried to move beyond databases and other “infrastructure” software (which together produce two-thirds of its revenues) and break into enterprise applications with its own programmes. When this failed, it decided to lead consolidation of the software industry and “surround” SAP with acquisitions, in the words of Larry Ellison, its chief executive. Since 2003 Oracle has bought more than 30 firms for about $25 billion in total. BEA does not sell applications, but it will help Oracle win new customers.

For years, SAP seemed unfazed by Oracle's shopping spree. It limited itself to buying smaller firms, either for their technology or to stop them going to Oracle. Its chief executive, Henning Kagermann, said organic growth would allow SAP to reach its goal of more than doubling its number of customers to 100,000 by 2010. Yet his decision to buy Business Objects is an admission that the firm now needs to react.

The acquisition game is likely to continue. But the most important battleground may be a different one entirely: the platform for the next generation of enterprise software. Whereas the industry has in the past mainly sold “monolithic applications”—big chunks of software to control things such as accounting and manufacturing—now it is moving to “services”: smaller software units that can be more easily combined to improve any business process. In recent years, SAP has spent heavily to develop a platform for such a service-oriented architecture, which it calls NetWeaver. In September it launched its first suite of programmes based on this new technology. Oracle has something similar it calls Fusion.

Which company is better prepared for the race? When Oracle went on its spending spree, many predicted failure: big software mergers have a poor record. But after initial problems the firm learned how to integrate acquisitions and boost financial results, says Bruce Richardson of AMR Research, a consultancy. Oracle's recent results have been impressive and its share price is rising. A key to its success is that it has largely kept the development teams of acquired firms intact, but it has yet fully to integrate their products with its own. Combining them in its Fusion software package is a huge task, says Brent Thill, an analyst at Citi Investment Research.

To Mr Thill, SAP is still the better-run and more innovative company when it comes to applications. Yet the firm has challenges, chief among which is how to keep growing as fast as it has in the past. Its revenues and profits are growing less than half as quickly as Oracle's, and its share price has been lagging. Buying Business Objects will help, but other takeovers may have to follow, argues Joshua Greenbaum of Enterprise Applications Consulting.

But Oracle is unlikely to overtake its rival in the market for enterprise applications soon. Even after all the acquisitions, Oracle has a market share of only 11% against SAP's 21%. The market is likely to end up a duopoly, at least in supplying large firms. That would not be the worst outcome for customers: as with Airbus and Boeing, the dominant aircraft manufacturers, two may be enough to keep prices down and spur innovation.

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Shipping and tax

Flagging off

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From The Economist print edition

Norway's shipping companies are furious about new tax rules

BE CAREFUL what you wish for. That should be the motto of Norway's shipping industry. For years, shipowners that fly the national flag have envied the more lenient tax treatment enjoyed by their rivals in the European Union. Norway's 2008 budget, which is being discussed in parliament this week, gives them a new deal closer to the EU's system of a flat tax based on tonnage. Shipping profits would become exempt from tax. But the massive one-off price exacted by the centre-left government is the payment of NKr21 billion ($3.9 billion) of deferred tax liabilities built up under the old system—a burden that could cripple many companies.

Now the air is thick with threats of Norwegian shipowners flocking to foreign flags, including the British "red duster", when they want new ships (Britain's shipping-tax regime is one of the most benign in the EU). The Norwegian Shipowners' Association has told the government that up to 45,000 jobs are at risk if such an exodus occurs.

Wilhem Wilhemsen, one of the industry's grand old family firms, has said it will register new vessels in Britain if the budget passes as it is. Solstad, a firm specialising in vessels that serve the offshore oil and gas industry, faces back-tax payments of up to NKr1 billion under the new plan. It already has ten ships flying Britain's red ensign and five under the flag of Singapore.

That is exactly what the government wants to avoid. Since 1996 Norwegian shipping firms have enjoyed a tax regime designed to stop them steaming off to the tax havens offered by flags-of-convenience countries such as Liberia or Panama. A small tax was levied on tonnage owned, and ordinary taxes on corporate profits were waived—or so it seemed. Taxes were levied on dividends and when assets were sold abroad. In exchange for this light touch, they had to keep investing in new ships, preferably built in Norway. Although the new system would benefit shipowners because their profits would be permanently exempt from tax, they had already come to see the old arrangement as being, in effect, permanent.

Now shipping lawyers are trying to prove that the retrospective taxation is unconstitutional. Norwegian shipowners also complain that, perversely, the new regime will benefit their colleagues who "flagged out" a decade ago. They will be able to come back home under the new EU-style system without having to pay any back taxes because they opted out of the regime now being phased out.

Shipping matters to Norway's economy, even though it has vast oil and gas reserves. The country has an ocean-going merchant fleet of some 1,600 vessels, 5% of the world's total, and about 60% of them still fly the national flag. The fleet's income accounts for about 11% of Norway's exports. To be sure, shipowners have threatened to leave before, only for most of them to stay at home after deals like the tax structure introduced in 1996.

A curiosity of Norway, which voted to stay outside the EU in 1994, is that many of its laws, especially on economic matters, are being remodelled strictly along EU lines. Except, it seems, in shipping, where they come with a strong whiff of Scandinavian socialism on top.

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Business in Germany

Locusts in lederhosen

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From The Economist print edition

German bosses are learning from private equity

TWO years ago Germany was gripped by a fierce debate over whether aggressive private-equity investors—dubbed “locusts” by a politician—were good or bad for the country. An activist fund from London blocked Deutsche Börse's bid for the London Stock Exchange and caused the departure of its chief executive, Werner Seifert, and its chairman. Mr Seifert wrote a vitriolic book, “Invasion of the Locusts”, catching the mood of the time. Since then, however, German bosses have learned from the locusts. They are making their own raids and using private-equity techniques to ginger up German companies.

Next week the European Court of Justice is expected to order the German government to abolish the Volkswagen law of 1960. This limits the voting rights of any single VW shareholder to 20%, protecting Germany's biggest carmaker from being taken over. Lifting this cap will allow Porsche, which already owns 31% of the shares, to win control.

Wendelin Wiedeking, chief executive of Porsche, began building a stake in VW two years ago. He plans to put the two carmakers under the same holding company, called Porsche Automobil Holding. In doing so, he would dilute the power of VW's workforce. Co-determination, the practice of giving workers a big say in the management of German firms, is probably the oddest feature of the country for foreign investors. Only three members of the merged company's 12-strong supervisory board would represent VW workers, compared with ten out of 20 at VW now.

Mr Wiedeking's strategy is the most obviously locust-like among German executives, but there are other examples. Eckhard Cordes, a former executive at DaimlerChrysler, a car firm, is riding roughshod into Metro, a retail group. He has the backing of the company's biggest shareholders—and these are not scary private-equity firms but two wealthy German families. Thomas Middelhoff, chief executive of Arcandor, another retailer, executed a private-equityish restructuring two years ago, loading the firm with debt then flogging assets to pay it off. Now he is in the mood to buy bits of other retail companies. Last year Manfred Wennemer, chief executive of Continental, a car-parts supplier, successfully repelled some potential private-equity buyers but seems to have learned a thing or two from them. This year his firm took on a pile of debt to buy Siemens VDO, an auto-electronics firm, for €11.4 billion ($16.2 billion).

More change is on its way. Nine of the 30 biggest listed German companies which make up the DAX stockmarket index have recently changed their chief executive or will do so soon. The new bosses are expected to shake things up. At Siemens, a giant engineering company, Peter Löscher will streamline the conglomerate's nine divisions into three. At BMW, Norbert Reithofer is expected to start a new brand of car to add to the group's BMWs, Minis and Rolls-Royces. At RWE, a power company, Jürgen Grossmann is likely to make use of the acquisition expertise he gained buying a division of Klöckner, a steelmaker, in 1993.

A new corporate structure, the Societas Europaea (SE), which has been adopted by Porsche Automobil Holding, could help German companies break further away from co-determination. Big firms must now have not only a management board but also a supervisory board of 20 members, half of them workers' representatives. Changing to SE status allows firms to negotiate a cut in workers' representation or even to do away with a supervisory board altogether. Allianz, a big insurer, was the first big company to move to the new structure, followed by Fresenius Medical Care. BASF, a chemicals company, plans to make the change next year.

In two years the names in the DAX could look very different, and not just because the initials AG (for *Aktiengesellschaft*) are replaced by SE. A big sell-out to foreign locusts is far less likely now, because German companies have learned to do the job themselves.

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Indian retailing

Mall rats

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Reliance moves into low fashion

MODELS in bubblegum-coloured T-shirts and skin-tight jeans sashay down a catwalk in a partially built shopping mall on the outskirts of Delhi. Builders stare from the balconies and windows of the mall's atrium as a compère extols “anti-stain trousers” and “ever-white shirts”. So Reliance Retail, a subsidiary of India's biggest private-sector company, marked the opening of its first clothes shop, branded Reliance Trends, on October 11th.

Reliance plans to open 100 such stores in India in the next three years. It has opened more than 300 shops including grocery stores since November. India's retail industry has sales of $300 billion, which will swell to $560 billion by 2012, says HSBC, a bank. Some 95% is accounted for by small, family-run “mom and pop” stores. By 2012, HSBC predicts, their share will have shrunk to about four-fifths as big, “organised” stores such as Reliance lure shoppers.

Most clothes shops in the organised sector sell expensive brands for wealthy buyers. Reliance Trends, with jeans at 199 rupees ($5), is aiming at India's middle class. Women in particular are expected to spend more on fashion. Traditionally, India has been one of the few countries in which sales of men's clothes have outstripped women's. But that is beginning to change: sales of women's clothing is now growing faster than menswear.

Small clothing stores will certainly suffer as firms such as Reliance expand. Archana Saluja, who sells salwar-kameez outfits from a tiny shop in south Delhi, says she has lost “many, oh many” customers to shopping malls and the fashion for jeans. Far fewer Indian women now wear salwar kameezes. One of her customers, Shilpi Sinha, a marketing executive, says she stays loyal to small, traditional shops because they sell unusual garments. “But for branded goods, like denims,” she says, “I go to the malls, of course.”

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Face value

Smooth operator

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From The Economist print edition

A Hong Kong entrepreneur shows Disney how to run a theme park

Courtesy of Ocean Park

“WE OWN Halloween,” says Allan Zeman. It would be a peculiar comment in most places, perhaps, but is well understood in Hong Kong, where October is a time when children flock to Ocean Park, an amusement park owned by the government. Its popularity is the result of a magical transformation wrought by Mr Zeman, a Canadian-born entrepreneur who originally made his money out of bars and women's clothes.

Four years ago Ocean Park was on its last legs, with attendance sliding and its facilities crumbling. A formidable new competitor, Disney, had arrived. Hong Kong's usual remedy for anything unprofitable is to flog it to a developer handy with the bulldozers. If 2003 had been a normal year, Ocean Park would have survived only as a memory. But the times were out of joint: in addition to the lingering financial crisis, SARS, a respiratory disease, had hit, and there were protests over the Chinese government's efforts to curtail civil rights. It was a bad moment to destroy something fun. In desperation, the island's then chief executive, Tung Chee-hwa, asked Mr Zeman to take over the park.

It was an odd choice. Before then Mr Zeman's main service to the public had been to transform warehouses into a wildly popular drinking district known as Lan Kwai Fong. Although Ocean Park was just a few minutes away from his office, Mr Zeman had never visited it. Startled by the offer, Mr Zeman said no, again no when it was repeated, and then no four more times. He relented after his sixth refusal, perhaps reasoning that since he had built successful saloons without being a drinker himself, he could run an amusement park without having taken a ride.

Four years later, the Mouse is stumbling and Ocean Park is thriving. At Disney's park attendance is widely reported to have fallen (the firm does not publish visitor numbers), whereas visitors to Ocean Park have increased from 3.7m in the year ending June 2004 to 5m for this year. Losses have become ever larger profits and Mr Zeman is walking on air, a Hong Kong hero who saved a local institution.

Mr Zeman's father died when he was young and he had to become independent. By the age of 16 he finished high school in Canada, having already earned more from his paper round, he says, than many of his friends' parents did from their businesses. He got a job as a shipping clerk for a Canadian lingerie company and then quickly moved into sales at another firm. Another job in women's-wear convinced him that the real problem—and hence opportunity—in the rag trade lay with Canada's trade unions, whose demands hurt profits. Aged 19, he opened his own business importing clothes from the more employer-friendly Far East. By 20, to avoid taxes, he was operating from Hong Kong.

From lingerie to jellyfish

Again, Mr Zeman quickly spotted a problem—the quotas America placed on imports from individual countries—and a chance to make money. He opened an office in China in Hunan province, Mao's birthplace (it worked for Mao, says Mr Zeman), and then more than three dozen offices throughout Asia. That way he could aggregate all the quota allowances. Mr Zeman sold the firm in 2000 to its largest Hong Kong competitor for HK$2.2 billion ($282m) in cash and shares.

Lan Kwai Fong began simply because Mr Zeman needed to keep the boyfriend of a talented employee happy. He gave him a restaurant in a quiet old warehouse; it turned into a huge success and then Mr Zeman added dozens of others. It helped that Wanchai, the main area for nightlife in Hong Kong, was then a fading red-light district filled with seedy hostess bars. But before Mr Zeman arrived, no one had noticed the gap in the market.

When he got to Ocean Park, Mr Zeman painted buildings, repaired cracks and dreamt up new entertainments. Often they were small and basic, such as people dressed as dead trees for Halloween and booths for kids to play with water squirters. A better-financed theme-park operator might sneer at such attractions, but they delighted Hong Kong residents and the mainland Chinese who are coming to Ocean Park in ever greater numbers. For Halloween last year Mr Zeman dressed as the paper doll that accompanies the dead to the other world (a particularly spooky sight for the superstitious Chinese) and as a jellyfish for a spring event. The press couldn't get enough of him.

Mr Zeman also introduced new marketing schemes, like free admission for grandparents and babies or because of a particular digit in someone's Hong Kong identification card. Each free guest was a lure for others who paid. Ocean Park also built up a big collection of fish, which allows parents to believe that they are treating their children to an educational experience, not just roller coasters. A recent coup was persuading Beijing to part with two pandas for the tenth anniversary of Hong Kong's reunification with the mainland.

Meanwhile, Hong Kong Disneyland got things wrong. It tried to customise rides for the safety-conscious Chinese by, for example, making them slower, but that made its park dull. It made logistical mistakes with some promotions, alienating visitors who were locked out. Disney's fees are higher than Ocean Park's, but the theme-park giant does not have the same fame and pricing power in Hong Kong as it does in America. Ocean Park offers a summer camp and invites schools to visit—anything it can think of to lure people in. Disney is more controlled: it has for instance built two fine baseball fields in Hong Kong, which is short of playing fields, but has sharply limited their use.

It is easy to find critics of Disney in Hong Kong, but Mr Zeman is not among them. He believes that Disneyland is improving and that a healthy Disney park is a good thing for Ocean Park and for Hong Kong. The more entertainment, he reasons, the more visitors and the more customers. Might he even be willing to work his magic for the Mouse?

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Northern Rock

Lessons of the fall

Oct 18th 2007
From The Economist print edition

Illustration by Stephen Jeffrey

How a financial darling fell from grace, and why regulators didn't catch it

A MONTH after Northern Rock made shocking headlines around the world, the full story of Britain's first bank run in 140 years has yet to be told. People were little the wiser this week, after Adam Applegarth, the mortgage bank's chief executive, and Matt Ridley, its chairman, tried to convince a sceptical parliamentary committee investigating the fiasco that they had been struck down by a bolt from the blue. The business model of Britain's fastest-growing mortgage bank—which funded its loan book mainly from the wholesale markets, rather than from retail deposits—had been prudence itself, they explained, derailed only by sloppy lending in America that caused those markets to seize up in August.

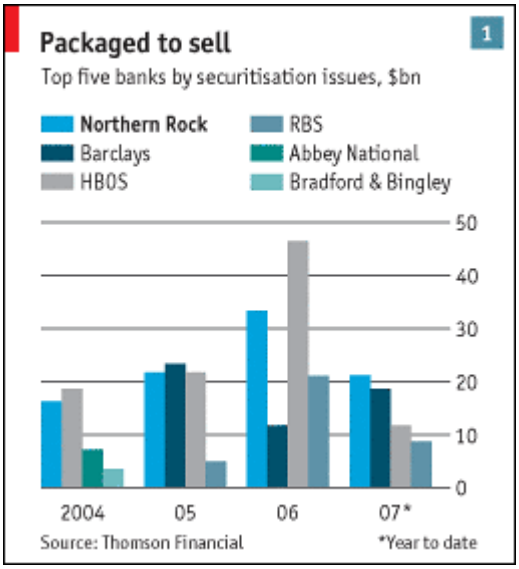
But their Northern Rock is now a busted flush. None of the three groups who talk of buying it at a knock-down price—a consortium led by Sir Richard Branson's Virgin Group and two private-equity outfits, Cerberus and J.C. Flowers—wants to keep its name. The bank, kept afloat at present by £13 billion ($26 billion) of public money, does not rule out going back to the Bank of England for more. And just as Northern Rock's bosses deny imprudence, so the central bank's governor, the head of the Financial Services Authority and the chancellor of the exchequer stoutly maintain that they were not responsible for the mess either.

Yet the story needs to be pieced together, for the debacle has had three important and unpleasant consequences. A financial institution that underpinned for years the economy and self-image of one of England's poorest regions, the north-east, has been destroyed. The reputation of a broadly good central-bank governor has been tarnished. And an admired regulatory system that helped to make London the world's biggest international financial centre has fallen into disrepute. What went wrong? What signals were missed? And what lessons should bankers and regulators both learn?

The faster they come

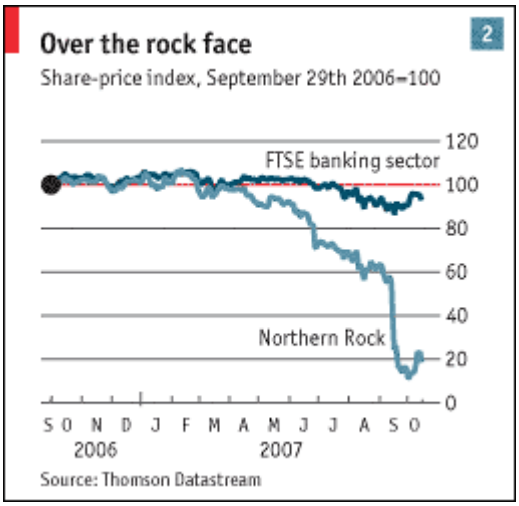
The year that Northern Rock fell from grace could hardly have started more promisingly. In January the bank announced record pre-tax profits of £627m for 2006, 27% higher than the previous year's. This marked a decade of success since its conversion in 1997 from a building society—a residential mortgage lender owned by its savers and borrowers—into a bank quoted on the stockmarket. Year after year its assets had grown by a fifth, even though it had few branches—128 when it converted and 76 this year. A small local lender had become Britain's fifth-biggest mortgage provider, ambitious to become its third-biggest before long.

The trick Northern Rock pulled off was to rely on wholesale markets rather than on retail deposits to finance most of its lending. More than any other big British lender, it relied on "securitising" its mortgages. The bank bundled its loans together and packaged them into bonds that it sold to investors around the world. In January 2007 it raised £6.1 billion that way; a second securitisation in May brought the first-half total to £10.7 billion and made Northern Rock the top securitiser among British banks (see chart 1). With money swirling around the world's capital markets, securitisation worked a treat. By tapping global wholesale markets, Northern Rock was able to raise money more cheaply than its home-bound rivals, price its mortgage offers more keenly and carry on its hectic expansion.



More securitisations were planned for later in the year. Northern Rock needed the money because it was growing even faster than before. In the first six months of 2007 its lending was 31% up on the same period in 2006; net of redemptions, lending soared by 47%. As HBOS, Britain's biggest mortgage lender, put on the brakes, Northern Rock's share of the net new-lending market jumped to 19%, an extraordinarily high share for a bank that had had just 7% of outstanding loans at the end of 2006.

Yet the bank's share price had been sliding (see chart 2). As the Bank of England pushed interest rates up sharply, the City was starting to worry about the prospects for mortgage lenders. Northern Rock appeared to have a good loan book: at the end of June, repayment arrears were just half the industry average (though mortgages seldom curdle immediately, and a third of fast-growing Northern Rock's were less than two years old). The bank suffered along with other mortgage lenders as financial folk pondered how far the fallout from America's excessive subprime (ie, high-risk) lending might spread.



Worries intensified in June when Northern Rock trimmed the year's expected profits growth from 17% to 15%. At a time when monetary policy was tightening faster than expected, the bank had agreed to issue a tranche of mortgages at interest rates that were lower than those it eventually had to pay in the markets to finance them. The episode highlighted the fact that its reliance on wholesale funding made it vulnerable.

An unknown unknown?

Northern Rock's profit warning led to a further slip in its share price. But banks do not answer to their shareholders alone. They are subject to special supervision, because a problem at one bank can undermine confidence in the whole system and do immense economic damage. The Bank of England had long been in charge of overseeing banks, and its record, though not flawless, was widely reckoned a good one. In 1997, however, when Gordon Brown, then chancellor of the exchequer, freed the central bank to set interest rates, he decided to hand bank supervision to a new Financial Services Authority. The FSA was to look after individual banks while the Bank of England remained responsible for the stability of the financial system.

A falling share price, an explosive increase in market share and a profit warning: three reasons, one might think, for a newish banking supervisor to start sweating about one of its charges. Yet the FSA remained cool. Indeed, it chilled out even more on June 29th, giving Northern Rock a stamp of approval that let the mortgage lender, under new international banking rules, set aside less capital against its loans. Northern Rock promptly announced an increased dividend (even though it expected profits to fall). At around the same time, bizarrely, the FSA was urging the lender to toughen its "stress tests".

The FSA's apparent insouciance was even stranger given Northern Rock's specific history. In 2004, after short-term interest rates shot up, the bank was caught off-guard, and profits suffered. It promised investors that half its loans would be matched by retail deposits—a pledge it promptly ignored once rates

moderated. By the time it hit trouble this year, just under a quarter of Northern Rock's funding came from retail customers.

But there were good reasons to doubt the wisdom of relying so heavily on the capital markets. Though retail deposits cost a lot to acquire, many banks still prefer them, for they are generally a more steadfast source of finance than wholesale funding. A former chief risk officer at one of Britain's biggest banks says that Northern Rock's operating model was very risky: “To say that nobody could have envisaged what happened doesn't wash at all.”

As long as five years ago Tommaso Padoa-Schioppa, now Italy's finance minister but then on the board of the European Central Bank (ECB), pointed out that the liquidity of financial markets had grown in importance. He gave a prescient warning: “The deepening of the markets has improved the ability of banks to access funds in normal times, but liquidity may be more prone to dry up when it is most needed.” In 2006 Moody's, a rating agency, cautioned that some British banks were exposed to the risk of disruption in wholesale markets because they were increasing their loans faster than they could gather the deposits to back them. More recently, the Bank of England itself highlighted in April the danger of liquidity risk in its *Financial Stability Report*.

Yet both Northern Rock and the FSA assert that the event that felled the bank—the complete failure of the various market-based funding sources upon which it had become reliant—could not have been foreseen. Mr Applegarth has stressed the speed, duration and global nature of the liquidity freeze that started on August 9th. “I didn't see this coming, I have yet to find someone who did,” he said. The FSA has played a similar card: in parliamentary testimony on October 9th, Sir Callum McCarthy, the regulator's chairman, insisted that the seizing-up of the money markets was unprecedented.

So neither the bank nor the FSA had incorporated such a scenario into stress tests of the bank's resilience. Indeed, the simulations carried out jointly by the FSA, the Bank of England and the Treasury to gauge the financial system's ability to withstand potential upsets (one of which, ironically, posited problems at Northern Rock) failed to involve banks themselves as players, and thus were unable to predict their likely behaviour in a crisis of this sort.

The timing of the liquidity freeze was, it is true, disastrous for Northern Rock, which was low on cash because its last securitisation had been in May and it was planning another in September. But even if the timing had been better, its strategy for dealing with a liquidity crisis proved to be little more than wishful thinking.

The bank had sought to diversify its funding sources around the world; but markets dried up globally. It had hoped for a flight to a quality loan book such as its own if investors became alarmed about subprime mortgages; instead, investors shunned anything to do with mortgages. Unlike Countrywide, an American mortgage lender that also got into trouble, Northern Rock had nailed down little money—only $3 billion, it emerged this week—in committed credit lines from banks that it could call upon in an emergency. And it had failed to take steps to increase its access to central-bank liquidity in a crunch. About 150 banks, some of them British, were able to tap the ECB through their branches in the euro zone. Northern Rock could perhaps have put mechanisms in place to use its outlet in Ireland. But the paperwork would have taken a few months; and by the time the bank thought of it, the moment had gone.

If Northern Rock's excuses fail to pass muster, so do those of the FSA. Hector Sants, who took over the job of chief executive in July, admitted on October 9th that the regulator should have been more forceful in its dealings with the bank, and accepted that stress tests had not been “extreme” enough. But both he and Sir Callum continued to depict the event as an “unknown unknown”.

Equally guilty was the new system of banking and financial-market supervision put in place by Mr Brown. Fragmented among three institutions, and manned by people who were either unaware of what was going on or unable to communicate what they knew to one another, it failed its first big test. Sir John Gieve, the Bank of England's deputy governor in charge of financial stability and also a non-executive director of the FSA, gave evidence to the parliamentary committee on September 20th along with Mervyn King, his boss at the central bank. “I was concerned in a general way about the growth of wholesale lending,” he said. “Did I know the details of Northern Rock's position before this blew up? No, I did not.” This institutional deafness was to become an increasing problem as the government sought solutions to the bank's worsening plight.

How not to handle a crisis

On Monday August 13th, two working days after the markets dried up, Northern Rock told the FSA it was in trouble. The message was passed on to the Bank of England and the Treasury the next day. All three institutions were supposed to deal with crises under a “memorandum of understanding” setting out their respective roles. The Treasury, which chaired the committee, was involved in these “tripartite” arrangements because helping a bank often requires a bail-out from the taxpayer.

By August 16th the possibility that the Bank of England would have to act as a “lender of last resort” to Northern Rock had already been raised. All three agreed, however, that it would be better for a stronger bank to take over the mortgage lender. Northern Rock put itself up for sale and feelers were put out in all directions. Lloyds TSB, a British bank, emerged as a serious contender, but the deal foundered on September 10th. Lloyds was prepared to step into the breach only if it was given a loan of up to £30 billion by the Bank of England; but the tripartite authorities agreed it would be “inappropriate to help finance a bid by one bank for another”.

Of the three, the Bank of England had taken the hardest line since the crisis began. Whereas the world's two main central banks—America's Fed and the ECB—sought at once to relieve the liquidity drought by injecting extra cash into the money markets and accepting a wider range of collateral than usual, the Bank of England did neither until September. It wanted to send a message that if bankers took excessive risks they could not look to the central bank to rescue them from the consequences. So the central bank resisted pleas—not just from private banks but also from the FSA—to copy its American and European counterparts.

Mr King's critics say that in his fixation on future crises he failed to deal with the one at hand. Mr Sants pointed out that logically the only replacement for private-sector liquidity, once it dries up, is central-bank liquidity. According to DeAnne Julius, a former member of the Bank of England's monetary-policy committee, “The first duty of a central bank is to retain confidence in the banking system, especially at a time of illiquidity, and our central bank didn't do that.”

A telling indication of Mr King's priorities emerged last year, when a new version of the memorandum of understanding came out. In the original agreement, dating from October 1997, the bank was “responsible for the overall stability of the financial system”. In the new version, however, it merely “contributes to the maintenance of the stability of the financial system as a whole”.

This anaemic wording contrasts with the Fed's “key role in the prevention and mitigation of financial crises”, which Ben Bernanke, its chairman, emphasised in a speech in January. Some charge Mr King with neglecting the subject since becoming governor in 2003. An executive director for financial stability respected for his close City contacts was replaced in that role by one without them. The bank's widely followed, half-yearly *Financial Stability Report* was halved in size and published erratically. Others with City connections have left the bank, reducing its “eyes and ears” in the market.

Once the deal with Lloyds TSB fell through, only the Bank of England could rescue the beleaguered mortgage lender. Mr King wanted to do this behind the scenes, as happened as recently as the early 1990s. His desire for a covert operation was, he said, thwarted by a European-inspired law, the Market Abuse Directive, which came into force in Britain in 2005.

Charlie McCreevy, the Brussels commissioner responsible for the directive, denied at once that it prevented a secret intervention in an emergency. But even if the gold-plated British version of it did make things harder, the bank should not have taken so long to figure that out. “You don't wait for the cinema to catch fire before you check out whether the fire precautions are going to work,” says Richard Lambert, head of the Confederation of British Industry and a former member of the MPC.

On September 13th Alistair Darling, the chancellor of the exchequer, had little choice but to agree that the central bank should provide emergency funding to Northern Rock. News of the impending rescue leaked out prematurely, and the government scrabbled to put out a public statement on September 14th.

To financial aficionados, the fact that Britain's central bank now stood squarely behind Northern Rock should have brought relief. But to ordinary people it sounded alarming, especially in its leaked version. Britain's flawed deposit-insurance scheme guaranteed fully only the first £2,000 of deposits, and then 90% of only the next £33,000 (though it has since been made more generous). Alerted to trouble, depositors raced to get their cash out before everyone else did. The bank run was stopped only on September 17th, when Mr Darling issued an unprecedented guarantee for all existing deposits at Northern Rock. Bafflingly, he extended this on October 9th to all new retail deposits as well.

Brickbats all round—and one lesson

No one emerges well from this tale. Northern Rock pushed an aggressive business model to the limit, crossing its fingers and hoping that liquidity would always be there. The FSA failed to spot the danger. The Bank of England worried too much about forgiving over-risky behaviour and too little about shoring up a stressed financial system. Mr Darling failed to reassure depositors when he eventually got round to it, then arguably reassured them too much when it no longer mattered.

But the biggest failure was the “tripartite” system, and its unreadiness in a crisis. Undoing the reform of 1997 that divested the central bank of supervision would be hugely disruptive; and other countries have divided central banks from banking supervision without seeing financial institutions go to the wall. But if Britain is to learn one lesson from the Northern Rock saga, it may be that a single outfit needs to be in overall charge of financial stability, the bedrock on which economies are built. Only a central bank can provide the liquidity needed in times of crisis. So whatever its failings this time, it is the Bank of England that should take responsibility and call the shots.

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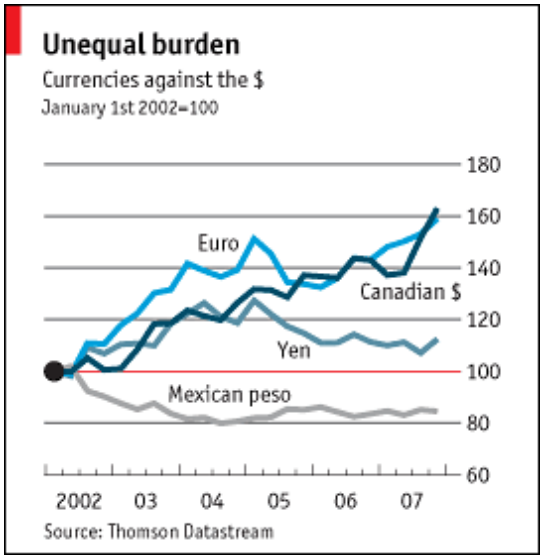
Exchange rates

Love the one you're with

Oct 18th 2007
From The Economist print edition

The euro area should learn to embrace a strong currency



AFTER a jittery summer in financial markets, it is a little strange to see analysts revising up their estimates of how America's economy fared during the tumult. Many now think GDP rose by 3% or more in the third quarter, a healthy pace even in less anxious times. That the source of much of the good cheer is a better trade performance seems odder still. America has habitually been more consumer than supplier: it has chalked up big deficits on its current account for years.

That may be changing. A weaker dollar—the greenback has slumped by more than a fifth since 2002 against the currencies of its trading partners—is helping America sell its wares abroad and is curbing its spending on imports. The trade deficit narrowed for a fourth straight month in August. Exports rose in cash terms by 12.8% from a year earlier and imports by just 3.0%. A welcome rebalancing of demand away from domestic spending towards exports seems to be under way.

Not everyone is celebrating, though. If America's goods are priced more keenly, others' must be relatively dearer. G7 finance ministers meeting on October 19th, ahead of the IMF/World Bank annual meetings between October 20th and 22nd, are likely to discuss renewed complaints that the euro has borne the brunt of the dollar's fall. Such grumbles have some substance. The euro area, Canada, China, Japan and Mexico together account for two-thirds of America's trade, but their currencies have fared rather differently against the dollar in recent years (see chart). Since the start of 2002 the euro and the Canadian dollar have risen most, the yen and the yuan by much less. The peso has fallen by nearly a fifth.

Although the euro has done more than its fair share of flexing, Canada may have more reason to carp about a weak greenback, as three-quarters of its exports go to America. And in many respects, the euro is well placed to bear an unequal share of the dollar's adjustment. As the oil price reaches a new high, activity in the euro area suffers least because of its energy efficiency. David Woo, currency strategist at Barclays Capital, points out that a big slice of revenues from oil-rich countries is spent on exports from Europe. Moreover, says Mr Woo, the euro area sells more than twice as much as America to the buoyant BRIC economies (Brazil, Russia, India and China) as a share of its GDP.

This exposure to such fast-growing markets helps mitigate the harm done to exports by a dear euro. Too often, though, the harmful effects of a strong currency are stressed, while the benefits are overlooked. Although a strong euro crimps sales abroad, it boosts spending at home: what exporters lose in pricing power, consumers gain in purchasing power. Cheaper imports raise households' real incomes, fuelling consumption. And by keeping a lid on inflation, they permit lower interest rates, which in turn stimulate domestic spending.

In the euro area, where household spending has been sluggish, a shift in demand away from exports and towards consumption, a mirror image of America's rebalancing, would be welcome. Leo Doyle, an economist at Dresdner Kleinwort, says the rise in the euro both anticipates and reinforces a changing mix to spending, much as the pound's sharp rise did in the mid-1990s. Indeed, the currency markets are paying the euro area a compliment: whatever the immediate doubts, the outlook for consumers appears brighter there than in either America or Britain, where saving rates are lower and debt levels are higher.

So why the complaints? One concern is that the dollar's steady decline will turn into a destabilising rout if investors lose faith in the greenback. Another worry is that an expensive euro will create unwanted trade deficits in Europe—though swapping cheap goods for assets in an expensive currency is surely a good

deal.

Euro-area governments are not united on the issue. Earlier this month Germany's finance minister, Peer Steinbrück, said the euro's rise was “nothing sensational”. His French counterpart, Christine Lagarde, has sounded rather more agitated—about the weakness of the yen and yuan as much as about that of the dollar. Italy too has expressed alarm.

This split mirrors a shift in competitiveness within the currency zone. After a decade of low wage growth, Germany can price its exports far more keenly than either France or Italy. There is also a divide that reflects differences in each country's product mix. Germany's capital-goods industry has profited from, rather than been hurt by, growth in emerging economies. But for exporters who compete directly with China, a strong currency hurts more. Euro strength is a “powerful market signal” that speeds up a necessary shift in resources to more profitable lines of work, says Mr Doyle. Perhaps that is what policymakers fear most: an exchange rate that is an agent for structural change.

Learning to love a strong exchange rate will be difficult, as long as anxieties about the global economy remain. In its semi-annual *World Economic Outlook*, released on October 17th, the IMF cut its forecast for growth in 2008 from 5.2% to 4.8%. America suffered the biggest downgrade, with expected growth slashed from 2.8% to 1.9%, hardly a dollar-friendly prospect. The euro area's GDP is expected to rise by 2.1% next year, marked down from 2.5%. The fund's economists note the euro's strength, but reckon “it continues to trade in a range broadly consistent with medium-term fundamentals”. So not everyone thinks the euro's rise has yet gone too far.

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Buttonwood

Paint it black

Oct 18th 2007
From The Economist print edition

The stockmarket crash of 1987 has lessons for today's markets

TWENTY years ago, stockmarkets experienced a severe sell-off that scarred the memories of all involved. On October 19th 1987 a fall of nearly 23% in the Dow Jones Industrial Average dragged down share prices round the world, in the first financial crisis of the modern globalised era. The day was dubbed Black Monday.

Much discussion of the anniversary focuses on whether it could happen again. The answer is, of course, yes; though trying to guess when is not very useful. It is more fruitful to reflect on the three lessons of the crash.

The first is that Black Monday was a “black swan”, to use a phrase popularised by Nassim Taleb, a trader and author. Just as those who had only ever seen white swans could not imagine one of a different colour, so nobody imagined that the markets could fall so far in a single day.

Finance professionals had traditionally assumed that market movements followed a statistical model known as the “bell curve”, in which most observations were clustered around the median and extremes were rare. On that basis, a 23% sell-off in one day would never have been expected.

Echoes of that view were heard during August's turmoil, when price movements were described as a “25-standard-deviation event”. Such remarks simply prove that market patterns do not fit the bell curve at all. Instead, they have “fat tails”: extreme events occur quite frequently.

The problem for traders is that it is much more complicated to create models for a world of fat tails than for a world of bell curves. As a result, traders repeatedly get caught out by “unprecedented” market movements. The collapse of two hedge funds, Long-Term Capital Management in 1998 and Amaranth Advisors in 2006, were cases in point.

Option-writing, an activity that insures the purchaser against asset-price movements, creates a particular danger. It brings in a steady income, since most options are not exercised. But in the case of fat tails, the losses for the option-writer can be so extreme that his capital is wiped out. Option-writing has accordingly been described as “picking up nickels in front of steamrollers”.

However, because several years can occur between fat-tail events, investors become complacent about option-writing. They, and the regulators, may believe that a fund manager or a bank is pursuing a prudent strategy when in fact the policy is highly risky.

The second lesson of the 1987 crash relates to portfolio insurance, a practice pursued by many institutional investors at the time. The idea was to sell futures contracts on the stockmarket; if share prices then declined, the profit in the futures market would offset losses on the underlying portfolio. But on Black Monday, a feedback effect was created. As investors sold futures to protect themselves against a crash, the cash price of shares was driven down as well. That prompted portfolio insurers to sell more futures, making the sell-off even more severe. Instead of protecting investors against a crash, the technique helped create it.

In short, it was impossible for the entire financial system to protect itself against risk. Someone had to take the losses. That lesson is also pertinent today. It was widely believed that, by selling debts in securitised form, banks were making the system more stable. But some of the buyers of those securities (hedge funds, conduits and structured investment vehicles) were ultimately dependent on the banks for finance. Risk had not been reduced by as much as the optimists hoped, let alone eliminated.

The third lesson is that central banks will quickly intervene if they fear the markets are in crisis. They did

so again in 1998 and in August and September this year.

Twenty years ago, the Fed feared a repeat of 1929: after that year's crash came the Depression. In fact, the economy shrugged off the meltdown with the help of a loosening of monetary policy and recession was postponed until the early 1990s. Indeed, Black Monday now looks like a blip on the long-term stockmarket graph.

Many investors came to believe that central banks would underwrite the markets (the so-called Greenspan, now Bernanke, put). Although central banks did not prevent the equity bear market of 2000-02, the current strength of the stockmarket suggests investors' faith in this put has not been eliminated.

But this could be the most dangerous lesson of all. In Japan in the 1990s, neither near-zero interest rates nor fiscal stimulus saved the market. One day, investors will realise central bankers are not magicians. That might be another Black Monday.

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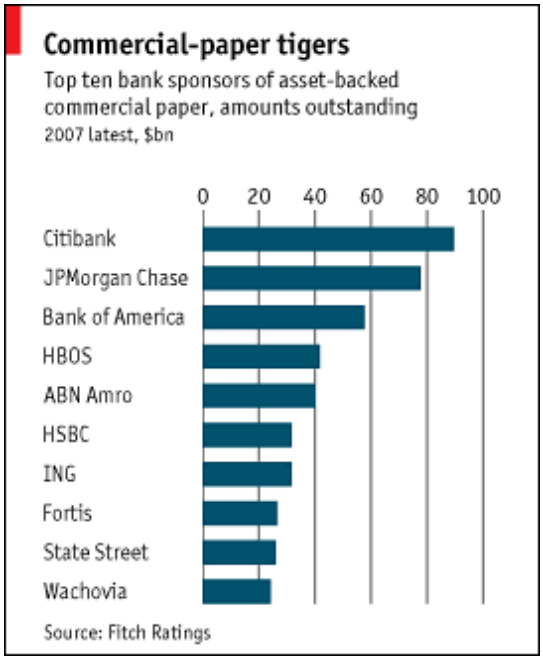
Credit markets

Curing SIV

Oct 18th 2007 | NEW YORK
From The Economist print edition

A bail-out fund raises more questions than answers

YOU know a market has seen better days when some of its leading actors are compared to a deadly virus. With many traditional buyers of commercial paper (short-term corporate debt) still on strike, Wall Streeters with more wit than taste have branded the sickliest of the structured investment vehicles (SIVs) that issue such paper to punt on longer-term assets "SIV-positive".



As the feeble struggle to roll over their debt, the banks with the most to lose from their demise are reaching for a palliative. Citigroup, JPMorgan Chase and Bank of America plan to set up a fund, expected to be worth up to $100 billion, that would buy assets from troubled SIVs. Though no government money will be available, the Treasury played a key role in its creation.

As demand for the asset-backed securities that SIVs buy has evaporated, some have had to sell holdings at fire-sale prices to repay investors. Since SIVs hold paper nominally worth $325 billion, further dumping could have a chilling effect on prices in other credit markets.

The new entity—clumsily labelled the Master-Liquidity Enhancement Conduit, or M-LEC—will essentially be a buyer of last resort, using the proceeds of its own debt issues to purchase assets from troubled SIVs. It will take only highly rated paper. By splitting this off from dodgy subprime assets, the hope is to tempt investors back and avoid an avalanche of forced selling. "Most commercial-paper buyers will touch only top-quality assets. A few are still happy to punt on rough stuff. But no one wants a murky mix of the two, which is what you have in many SIVs now," says a person close to the fund.

There is a whiff of self-rescue about the enterprise, especially with regard to Citigroup, which is more exposed to the asset-backed commercial-paper market than any other bank (see chart). However, rumours have been circulating that British banks were also keen to see a rescue fund established, as they hold a large share of the SIVs' most toxic tranches.

Nevertheless, it is too early to say whether the scheme will work, or even happen. Much is still to be thrashed out. The banks may struggle to reach agreement on a host of issues, not least the price at which to buy assets. Nor is it clear that other banks, investors or even SIVs will participate. European banks are conspicuously absent, so far, as are investment banks. Commercial-paper investors may find the M-LEC's complexity a turn-off. And it will not be lost on them that the bankers peddling the scheme are the same whose misvaluation of debt securities caused the problems in the first place.

Participating SIVs will have a stake in the enterprise, but taking part may prove expensive. Some 4% of the payment will be not in cash but in junior notes, which will end up worthless if the assets don't perform. The fund will also charge them a fee for taking on their assets. It is structured to keep most of the credit risk in the SIVs it helps. The banks that provide credit lines to it will incur losses only after lower tranches held by the SIVs and outside investors have been wiped out, which seems unlikely even in current conditions.

Joseph Mason, a finance professor at Drexel University, sees bigger problems. He argues that voluntary co-guarantee schemes like this are doomed to failure because only the weakest institutions want to participate. Like Groucho Marx, the SIVs that most easily qualify for membership of the club will be the least likely to want to join, since they will have cheaper funding alternatives. He also worries that the

fund's creation suggests “we now have an entire market that's deemed too big to fail.”

Even those who support the fund admit that it is, at best, a temporary solution, buying time so SIVs can find other sources of finance or wind down gracefully. It may also provide breathing space in which to sort out deeper problems facing the market, such as the unstable structure and opacity of SIVs. “The market has to move to a new business model,” says a senior Treasury official.

That means wrenching change, which may explain why stockmarkets fell on the day of the announcement. To some, the Treasury's participation signalled that things were worse than feared. Much of the week's other news seemed to bear this out: Nomura, Japan's largest securities house, said it would take a $620m write-down on mortgage-backed securities; and Citigroup posted a 57% drop in quarterly profits and said parts of the debt market might not recover soon.

The consolation for banks is that they, too, have buyers of last resort. Citic, a Chinese bank, this week said it had considered bidding for a stake in Bear Stearns, a Wall Street firm whose share price has slumped thanks to hefty mortgage exposure, though no deal was imminent. If M-LEC fails to take off, the bottom-fishers will soon have others to nibble at.

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The World Bank

A stitch in time

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From The Economist print edition

The World Bank's new president wants to keep the institution intact

IN THE spring the World Bank was coming apart at the seams and in need of some emergency repairs. But its new president, Robert Zoellick, has higher ambitions than that. He enters his first annual meeting of the institution, which kicks off on October 20th, keen to knit the bank's jumbled parts into a coherent whole.

First, the repairs. Mr Zoellick inherited an unhappy staff. They had openly revolted against his predecessor, Paul Wolfowitz, who was accused of favouritism towards his girlfriend, a bank employee. Staff grievances were also aimed at a handful of Mr Wolfowitz's allies and appointees. A quick lustration might have followed the handover of power. But Mr Zoellick has tried to deal with disgruntlement by hiring insiders rather than firing misfits. His new chief of staff, Caroline Anstey, joined the bank more than ten years ago. He has picked a third managing director, Ngozi Okonjo-Iweala, who is returning after a brave term as a reforming finance minister of Nigeria.

AP

It's Bob's big weekend

Having patched over the staff's differences, Mr Zoellick's most urgent task is securing generous funding for the bank's aid arm, known as the International Development Association (IDA). It hopes to raise about $33 billion to dole out to 81 poor countries over three years, beginning in July 2008. Mr Zoellick's pitch for IDA funding is much the same as his predecessor's. The money is required to “unify” the fragmented aid programmes of governments and philanthropists, who often flock to eye-catching causes, such as AIDS, while neglecting worthy but dull ones, such as hospital refrigeration.

Although the talk is not new, Mr Zoellick argues that the bank has now “put our money where our mouth is.” He has secured a $3.5 billion contribution to the bank's aid coffers from two other parts of its empire: its loan arm to middle-income countries, such as Turkey, and the International Finance Corporation (IFC). Both bits of the bank are flush at the moment. Its loan arm is sitting on capital worth about 33% of its lending. The IFC, which makes loans and investments to kick-start the private sector in poor countries, has retained profits of $11.3 billion.

Mr Zoellick, who recently worked for Goldman Sachs, looked at these balance-sheets with an investment banker's eyes and concluded that this capital should be made to work a lot harder. If the IFC has more money than it knows how to use, why not shuffle some of it to IDA? “You can have your cake and eat it too,” he says.

The transfer demonstrates the urgency of IDA's funding needs. But it also hints at the potential redundancy of some of the bank's broader offerings. Its capital-to-loan ratio is so high partly because its loan book is dwindling. Its traditional customers, such as Latin American governments, borrow less than they did and find less bothersome creditors in the private markets. Some of the bank's critics think it should declare victory and go home.

Mr Zoellick has instead cut and simplified the bank's rates and fees to win back some of their custom. He is also considering looking elsewhere for customers: perhaps Vietnam, which currently benefits from IDA aid, could repay a harder loan.

By transferring money and sharing customers between one bit of the bank and another, Mr Zoellick is trying to stitch the bank together so that the “whole is greater than the sum of the parts”. He will be hoping that his knitting needles fend off the bank's critics who would rather take a pair of scissors to the

institution.

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India's markets

Too hot to handle

Oct 18th 2007 | MUMBAI
From The Economist print edition

India cracks down after a stockmarket and rupee rally

WHEN the world's equity investors rediscovered their appetite for risk after the Federal Reserve cut interest rates on September 18th, they took a particular liking to anything curry-flavoured. In less than a month, India's benchmark Sensex index climbed by more than 20%, and on October 15th it hit yet another a new record. The inflows of capital pushed the rupee to its highest level in more than nine years.

That was enough for India's cautious regulators, who fear that speculative money from abroad may interfere with efforts to cool the country's sizzling economy. After the market closed on October 16th, the securities regulator unveiled rules it proposes for foreign investors who are not registered in India. The news hit sentiment like a bucket of cold water; on October 17th the stockmarket slumped by more than 9% in a few minutes, leading to a one-hour trading suspension. The rupee also tumbled. (The index pared back its losses after some soothing words from government officials, closing down 1.8%.)

India's financial authorities are particularly concerned about a problem that has caught the attention of their peers elsewhere in Asia: the difficulty they have in keeping track of the more opaque inflows of money. Foreigners have invested close to $18 billion in Indian shares this year, more than half of which is estimated to have been in the form of derivatives, known as participatory notes. These are sold to offshore investors by approved institutions. They allow the buyers such as hedge funds to gain exposure to Indian stocks without acquiring the actual securities and without registering with the Securities and Exchange Board of India (SEBI). In more than three years, the number of institutions issuing the notes has risen from 14 to 34, and the notes' face value has risen more than tenfold to 3.5 trillion rupees ($88 billion).

SEBI's proposal (it intends to make a final decision on October 25th) is to stop the issue of new participatory notes based on equity derivatives, and to wind down outstanding positions over the next 18 months. About one-third of the notes are linked to equity derivatives. The proposal also aims to limit notes based on actual shares.

Palaniappan Chidambaram, the finance minister, said that the proposed rules were aimed at moderating “copious” capital inflows. Meleveetil Damodaran, SEBI's chairman, suggested they were also intended to improve transparency. He invited foreign investors to come in “through the front door.” The notes have long been controversial but the government's actions this week should have taught some important lessons to all concerned: first, that investing in India is not an open goal; and second, that playing with capital controls—even on the market's murky edges—can be a dangerous game.

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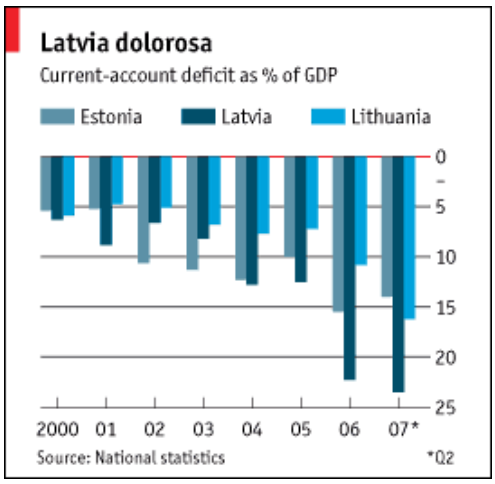
Eastern Europe

Baltic blues

Oct 18th 2007 | TALLINN
From The Economist print edition

Europe's fastest-growing economies hit choppy waters

Get article background



DEVALUATION would be horribly painful and solve nothing. That is Latvia's defence, as its inflation rate and current-account deficit soar, and speculators hover over its pegged exchange rate. On paper, the small Baltic economy looks nastily exposed, as, to a lesser extent, do its neighbours Lithuania and Estonia (see chart). All three have overheating economies and fixed exchange rates: a risky mix. Some fear the region could be eastern Europe's Achilles heel.

Latvia is in the worst situation. Year-on-year inflation in September was a whopping 11.4%; the current-account deficit over a fifth of GDP. Bank lending, much of it in foreign currencies, has soared, creating a property bubble in the capital, Riga. Overheating has hurt competitiveness. To some the national currency, the lat, looks like the likeliest casualty.

Latvia's position was not helped when Jürgen Stark, a board member of the European Central Bank, said earlier this month that ex-communist countries wanting to join the euro zone faced “substantial challenges”, banker-speak for “forget it”; Lorenzo Bini Smaghi, another ECB board member, publicly questioned the ability of these countries to keep inflation under control while maintaining fixed exchange rates, a stance that means adopting what is *de facto* the euro zone's monetary policy.

Yet a devaluation is far from inevitable. The Latvian banking system is largely foreign-owned. If overstretched borrowers start to default, that will hurt shareholders abroad, mainly in Sweden, not the stability of the whole financial system. If scared banks rein in lending and construction companies go bust, that would help produce a much-needed soft(ish) landing. Indeed, that may already be under way. Furthermore, speculating against thinly traded currencies is tricky. It may also be pointless: the Latvian central bank has enough reserves to redeem every lat in circulation, and more besides. And as Jon Harrison of Dresdner Kleinwort, a bank, points out, Latvia has little foreign debt and a strong credit rating. It could borrow in euros to ease a local credit squeeze.

The problem for Latvia is the lack of monetary-policy levers. The currency peg means it cannot raise interest rates. Even when banks cut back on their lending, other financial entities, such as leasing companies, can fill the gap. That leaves only fiscal policy; yet the government, an uninspired coalition stronger on business practice than economic theory, has shied away from the big surplus that might slow the economy and reassure outsiders. The 2008 budget foresees a surplus of only 1%, rising to 1.5% in 2010. Outsiders think 3% would be a good start.

A forced devaluation in Latvia would be ruinous for the middle class—at least for those who stayed to experience it. Tens of thousands of Latvians have gone to work abroad already. Any gain in nominal competitiveness might well be counterbalanced by an even tighter labour market.

Estonia and Lithuania would be at risk if Latvia did devalue. But elsewhere, a crunch in the Baltics would be more spectacular than significant. The combined GDP of the three Baltic economies is barely 1% of the euro zone's. Their plight might worsen wobbles in Kazakhstan, say, but most other ex-communist countries would weather the storm. The main change would be in the mood music. When liquidity was plentiful, lending in eastern Europe looked like a source of easy profit. Now the region's bottlenecked economies and lacklustre governments stand more harshly exposed.

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Commodities

Material world

Oct 18th 2007
From The Economist print edition

Oil is not the only commodity on a tear

AS OIL prices touched $89 a barrel this week, the temptation was to seek an explanation in geopolitics. Many cited a potential incursion by Turkish soldiers into northern Iraq. Some believed gold's rise to a 27-year high was driven by the same factor.

But the commodities market is being affected by a lot more than just events in the Middle East. Prices of raw materials are seeing widespread gains as talk of a “supercycle” is in the air. Copper, lead, soyabeans, wheat, cotton, coffee, cocoa and feeder cattle have all registered double-digit percentage gains this year.

AP

Fuelling the supercycle

Some of these gains can be traced back to the rise in oil prices. The planned substitution of ethanol for petrol encouraged corn planting, which took acreage away from crops like soyabeans and led to a surge in prices. Higher livestock prices can, in turn, be explained by higher grain costs.

But the broad strength of commodity prices may also reflect the appeal of the sector as an “alternative asset”, along with hedge funds and private equity. Ever since the dotcom bubble burst, investors have been keen to diversify away from shares and government bonds. That has led to the launch of a whole series of exchange-traded funds based on commodities, which have made the asset class accessible for a much wider range of investors. The latest example, from Barclays Global Investors, a big asset manager, is a fund based on timber prices. Wall Street has been gearing up to meet demand: a survey by Options Group, a recruitment consultant, found that the hiring rate of commodity traders is up by 33% on last year.

The recent credit crunch may have given commodities a further lift. Speculative money that had been flowing into high-yield bonds and structured credit is now looking for a new home. Some commodities, particularly gold, are also seen as a hedge against a declining dollar.

Robin Bhar, a metals strategist at UBS, says investors seem to feel they have an each-way bet on commodity prices. Either global economic growth is strong and supply remains tight, or the world slips into stagflation, as it did in the 1970s. Commodities should perform well either way.

Such a bet could still lose money, of course, if the world slipped into a non-inflationary recession. But investors seem to feel that the global economy can overcome the problems in the American housing market. Peter Oppenheimer, a strategist at Goldman Sachs, says that high metals prices reflect the strength of the BRIC economies (Brazil, Russia, India and China), which contribute twice as much as America to global consumption growth.

Individual commodity prices are still highly volatile thanks to speculative demand. A sharp rise tends to attract “momentum” investors, who push prices up even further until end users start looking for alternatives. At that point, the momentum buyers retreat. But oil's attractions to investors have increased recently because the market has moved into “backwardation”, where futures prices are lower than the current price. Investors can thus earn a “roll yield” by buying the future and waiting for the

price to rise to the spot level.

The key factor, however, is the tightness of supply. Francisco Blanch of Merrill Lynch reckons that supply contracted by 500,000 barrels a day in the third quarter while leading economic nations entered the fourth quarter with their lowest stocks for four years. Mr Blanch reckons it would not take much to push the price to $100 a barrel. If it gets there, stockmarkets may face an interesting test of confidence.

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Economics focus

Intelligent design

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From The Economist print edition

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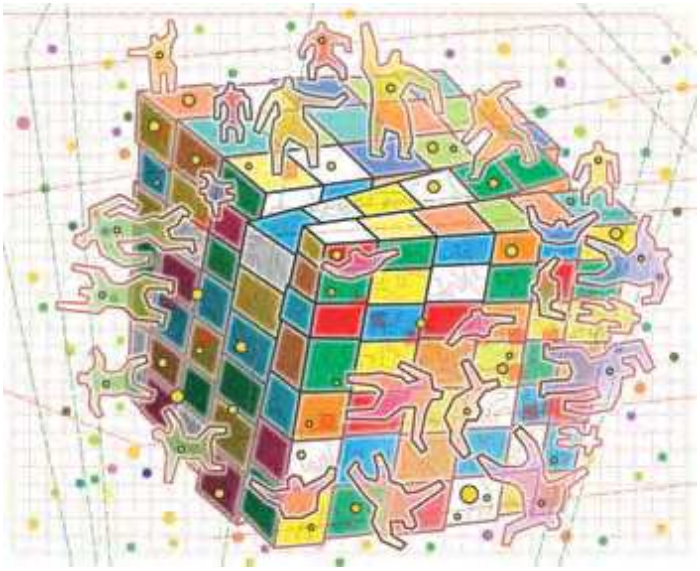

A theory of an intelligently guided invisible hand wins the Nobel prize

“WHAT on earth is mechanism design?” was the typical reaction to this year's Nobel prize in economics, announced on October 15th. In this era of “Freakonomics”, in which everyone is discovering their inner economist, economics has become unexpectedly sexy. So what possessed the Nobel committee to honour a subject that sounds so thoroughly dismal? Why didn't they follow the lead of the peace-prize judges, who know not to let technicalities about being true to the meaning of the award get in the way of good headlines?

In fact, despite its dreary name, mechanism design is a hugely important area of economics, and underpins much of what dismal scientists do today. It goes to the heart of one of the biggest challenges in economics: how to arrange our economic interactions so that, when everyone behaves in a self-interested manner, the result is something we all like. The word “mechanism” refers to the institutions and the rules of the game that govern our economic activities, which can range from a Ministry of Planning in a command economy to the internal organisation of a company to trading in a market.

Leonid Hurwicz, Eric Maskin and Roger Myerson won their third-shares of the $1.5m prize for shaping a branch of economics that has had a broad impact, both in academia, in subjects such as incentive theory, game theory and the political science of institutions, and in the real world. It affects everything from utility regulation and auctions to structuring the pay of company executives and the design of elections. Mr Hurwicz must be especially delighted as, aged 90, he is the oldest ever Nobel winner, and may have thought his chance had gone. He worked long ago with one previous winner, Kenneth Arrow, and was the graduate adviser to another, Daniel McFadden. One of his most influential papers was published when he was 55, about the same age his co-winners are now, which proves, if nothing else, that making big intellectual breakthroughs is not exclusively a young person's game.

Mechanism-design theory aims to give the invisible hand a helping hand, in particular by focusing on how to minimise the economic cost of “asymmetric information”—the problem of dealing with someone who knows more than you do. Trading efficiently under asymmetric information is hard, for how do you decide what price to offer someone for something—a product, say, or their labour—if you do not know at what price they would sell it? On the one hand, you may not offer enough to get them to deliver the product or work, or at least do so adequately; on the other, you may overpay, wasting resources that might have been better used elsewhere.

Mr Hurwicz took up economics at a time when debate was raging about the relative merits of central planning and the market mechanism. While agreeing with the great libertarian, Friedrich von Hayek, that the dispersion of information was at the heart of the failure of planning, Mr Hurwicz saw that it went deeper than that. He observed that there was a lack of incentive for people to share their information with the government truthfully. Moreover, although the market mechanism was far less afflicted than central planning by such incentive problems, it was by no means immune from them.

His big idea was “incentive compatibility”. The way to get as close as possible to the most efficient economic outcome is to design mechanisms in which everybody does best for themselves by sharing truthfully whatever private information they have that is asked for. Even this cannot guarantee an optimal outcome, Mr Hurwicz showed, because the existence of any private information precludes the economist's holy grail, known as Pareto efficiency, even if everyone's incentives are compatible. But it will get closer to it than if incentives are incompatible (ie, when some people can do better by not sharing information or lying). Pareto efficiency means that no one can be made better off without someone becoming worse off. Mechanism design has “incentive efficiency”: given compatible incentives, no one can do better without someone doing worse.

Across the spectrum

Mr Hurwicz's theories deployed some very elegant mathematics. Starting in the 1970s mechanism design was taken to a new level of sophistication and complexity thanks to the simultaneous boom in computing power and game theory. It was increasingly put to work on tasks ranging from how to auction a radio spectrum to devising a better way of paying defence contractors than cost-plus contracts (which create incentives for the contractor to be inefficient) or fixed-price contracts (which may result in overpaying).

Mr Myerson's biggest contribution to mechanism design is his work on the “revelation principle”, a mathematical method that simplifies calculation of the most efficient rules of the game for getting people to reveal their private information truthfully. Mr Maskin's breakthrough was “implementation theory”, which clarifies when mechanisms can be designed that only produce equilibria that are incentive efficient. He has also given his name to a statistical condition called “Maskin monotonicity”, which might not be the sort of thing to mention at parties.

The work of this year's winners is closely related to that of several earlier laureates, including William Vickrey and James Mirrlees, John Harsanyi and John Nash, the game theorist whose life story was made into an Oscar-winning film, “A Beautiful Mind”. Mr Maskin lives in a house in Princeton once home to Albert Einstein (and at least one other Nobel laureate), and he dresses up as the great physicist at Halloween, so there may be the makings of a plot there. Yet, despite the importance of the topic, *The Economist* suspects there are no plans for “Mechanism Design—The Movie”.

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Malaria

Exterminate! Exterminate!

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New malaria vaccines—and a pep talk from the man who is paying for some of them—are raising the idea that malaria might be eliminated once and for all

Getty Images

“WE'VE made vaccines from pus and poop, we make them now using eggs—so why not make them in live mosquitoes?” So says Stefan Kappe, a researcher at the Seattle Biomedical Research Institute. To prove the point, his team is breeding millions of *Anopheles* mosquitoes (pictured above) and infecting them with malaria-causing parasites.

Not any old parasites, either. Those he uses have had some of their genes knocked out to stop them breeding in humans. Their destiny, like that of the “attenuated” viral strains grown in eggs, is to form part of a vaccine.

Once the parasites have had time to breed in the mosquitoes, the insects are killed and dissected under a microscope. The gold inside them is their salivary glands, the parts richest in parasites. These are extracted, processed and turned into what Dr Kappe hopes will become a successful vaccine. By injecting this vaccine of pared-down parasites into uninfected individuals, he intends to provoke an immune response to malaria that will be strong enough to kill a real infection before it gets going.

Provoking such a response is, of course, the idea behind any vaccine, and there are various ways of doing it. Dr Kappe's looks promising in the laboratory, but has yet to undergo clinical trials. Another method, however, has been on trial for several years by Pedro Alonso of the Barcelona Centre for International Health Research. This week saw the publication in the *Lancet* of the latest results from those trials. They look very promising indeed.

Surface and depth

The vaccine created by Dr Alonso and his colleagues has been tested on infants aged under five months in a region of Mozambique where the disease is endemic. It did not provide complete protection, but the infection rate observed over the course of the subsequent six months was 65% lower than in members of a control group, who were given a hepatitis B vaccination instead. And it was also safe—an important consideration, since infants are both the people most vulnerable to malaria and those in whom it is easiest to provoke adverse reactions.

Unlike Dr Kappe's vaccine, this one does not rely on injecting whole, attenuated parasites. Instead, some

of the proteins that adorn the parasite's surface have been made in bulk. The vaccine is thus, in effect, all surface. Since the immune system can see only the surface of even a whole parasite, that is the only part it can learn to recognise, so a vaccine consisting of parasite surface and nothing else should be good at stimulating an immune response—and it is.

Dr Alonso's paper, then, is a bit of good news in an area—global health—that is more usually associated with misery. It is not, however, the only optimistic note as far as malaria is concerned. A newish and very effective drug called artemesinin is now being deployed, and the campaign to distribute insecticide-laced bed nets through large parts of Africa is also showing signs of success. A few people are therefore daring to whisper a word that has not been heard much in malaria circles since the 1960s: eradication.

On October 17th, the day Dr Alonso's paper was published, someone dared do more than whisper the word. Bill Gates almost shouted it at a conference on the disease which was organised in Seattle by his foundation. The Gates Foundation helped to finance the trials in Mozambique and Mr Gates used their success to give a rousing speech to the gathered experts, challenging them to raise their sights. Rather than continue with today's strategy of merely controlling malaria, he argued that it is time for the world to aspire to exterminate it altogether.

This is not a new idea. The last attempt to eradicate malaria began in 1955 (coincidentally, the year Mr Gates was born) and relied on a new wonder chemical called DDT to kill the mosquitoes. For a time, it was successful, but then evolution struck back, as natural selection favoured the spread of insecticide-resistant genes. Shortly afterwards, politics struck back, too, as the environmental movement successfully demonised DDT because of the damage it does to many other animals.

Given this history, cynicism about the idea of eradication is understandable. Steven Phillips, chief medical officer of Exxon Mobil, a firm whose African operations are inevitably affected by malaria, argues that eradication is technically impossible and favours emphasis on “bread and butter” disease control. But Regina Rabinovich and Tachi Yamada, the scientists responsible for running the Gates Foundation's anti-malaria effort, argue that eradication was never seriously attempted in Africa in the past. They think that today's money, technologies and political will are strong enough to make eradication a realistic aspiration.

Dr Phillips is right, in the sense that even the finest vaccine cannot do much good if it does not reach villages in endemic areas. However, things change—even in Africa. A report released this week by Unicef, the United Nations Children's Fund, suggests several countries, including Ghana, Tanzania, Benin and Gambia, are making progress in spreading artemesinin and bed nets.

Eradication would not be cheap. A back-of-the-envelope estimate suggests it would cost about $9 billion a year for two or three decades to make and distribute the necessary vaccines, drugs and equipment. But that compares with $3 billion a year indefinitely, merely to contain the problem—not to mention the economic damage done by the disease. Big ideas have to await the right time to be realised. But for malaria that time may be now.

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Evolution

Live fast, love hard, die young

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Chasing females can take years off life

IN THE cause of equal rights, feminists have had much to complain about. But one striking piece of inequality has been conveniently overlooked: lifespan. In this area, women have the upper hand. All round the world, they live longer than men. Why they should do so is not immediately obvious. But the same is true in many other species. From lions to antelope and from sea lions to deer, males, for some reason, simply can't go the distance.

One theory is that males must compete for female attention. That means evolution is busy selecting for antlers, aggression and alloy wheels in males, at the expense of longevity. Females are not subject to such pressures. If this theory is correct, the effect will be especially noticeable in those species where males compete for the attention of lots of females. Conversely, it will be reduced or absent where they do not.

To test that idea, Tim Clutton-Brock of Cambridge University and Kavita Isvaran of the Indian Institute of Science in Bengalooru decided to compare monogamous and polygynous species (in the latter, a male monopolises a number of females). They wanted to find out whether polygynous males had lower survival rates and aged faster than those of monogamous species. To do so, they collected the relevant data for 35 species of long-lived birds and mammals.

As they report this week in the *Proceedings of the Royal Society*, the pattern was much as they expected. In 16 of the 19 polygynous species in their sample, males of all ages were much more likely to die during any given period than were females. Furthermore, the older they got, the bigger the mortality gap became. In other words, they aged faster. Males from monogamous species did not show these patterns.

The point about polygyny, according to Dr Clutton-Brock, is that if one male has exclusive access to, say, ten females, another nine males will be waiting to topple the harem master as soon as he shows the first sign of weakness. The intense competitive pressure means that individuals who succeed put all their efforts into one or two breeding seasons.

That obviously takes its toll directly. But a more subtle effect may also be at work. Most students of ageing agree that an animal's maximum lifespan is set by how long it can reasonably expect to escape predation, disease, accident and damaging aggression by others of its kind. If it will be killed quickly anyway, there is not much reason for evolution to divert scarce resources into keeping the machine in tip-top condition. Those resources should, instead, be devoted to reproduction. And the more threatening the outside world is, the shorter the maximum lifespan should be.

There is no reason why that logic should not work between the sexes as well as between species. And this is what Dr Clutton-Brock and Dr Isvaran seem to have found. The test is to identify a species that has made its environment so safe that most of its members die of old age, and see if the difference continues to exist. Fortunately, there is such a species: man.

Dr Clutton-Brock reckons that the sex difference in both human rates of ageing and in the usual age of death is an indicator that polygyny was the rule in humanity's evolutionary past—as it still is, in some places. That may not please some feminists, but it could be the price women have paid for outliving their menfolk.

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Quantum cryptography

Heisenberg's certainty principle

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The Swiss are using quantum theory to make their election more secure

HANGING chads. Ballot stuffing. Gerrymandering. Such dirty tricks enfeeble democracy. But the security of the votes cast in Geneva during Switzerland's general election on October 21st is guaranteed. The authorities will use quantum cryptography—a way to transmit information that detects eavesdroppers and errors almost immediately—to ensure not only that votes are kept secret but also that they are all counted.

In quantum cryptography, as in most long-distance data transmission, the information is carried by photons, the particles which compose light and other sorts of electromagnetic radiation. These particular photons, however, are manipulated in a special way. The simplest example is when the sender (whom cryptographers usually call Alice) dispatches a stream of them to the receiver (who is known as Bob). These photons will have one of two modes. In the first, a photon is polarised either vertically or horizontally. In the second, it is polarised diagonally—plus or minus 45°. In the first mode, a photon polarised vertically represents a “0” and one polarised horizontally represents a “1”. Similarly, in the second mode polarisation at +45° represents “0” and at -45°, “1”.

Bob's receiver can be set to only one mode at a time, so if Alice sends him a vertically polarised photon and his equipment is in the first mode, then he will record a “0”. If his equipment is in the second mode, he will have an equal chance of recording a “0” or a “1”. After a short time, Alice tells Bob that the photon she sent should have been measured in mode one; she does not tell him what value it should have been. Bob now knows whether he made a correct measurement. If he did, he keeps the result and tells Alice that they have a match. If not, he junks it and tells Alice to do likewise—a process that takes a few millionths of a second.

It is at this point that Eve may show up. Eve is the name that cryptographers give to an eavesdropper. Should Eve intercept the transmission, the laws of quantum mechanics mean that she cannot read it without altering the photon in some way. By recording each photon, she actually destroys what she is measuring. She must therefore generate some new photons and send these to Bob, in the hope that he doesn't twig what is going on. But her equipment, too, must be set to one mode or the other, and she cannot be certain that the polarity of the photon she sends to Bob is correct.

This means that if Eve is involved, when Alice and Bob come to compare their data there will be many more mistakes than would otherwise be expected. Eve's presence will thus quickly be revealed and appropriate countermeasures can be taken. And the system works not only when there is an intelligent eavesdropper on the line, but also when data become corrupted accidentally.

For a truly secure system, the message will be encrypted in a way that requires a mathematical key to unlock it. In fact, both key and message can be transmitted this way: if the key is sent first, any interception will be detected and the key discarded. Only when the key has been safely transmitted need the message itself be sent.

This being Switzerland, it is unlikely that anyone will try a bit of electronic ballot-stuffing in this particular election, so it is the anti-accidental-corruption feature that is of most interest to Geneva's returning officers. And in truth, this is as much a piece of advertising as a real application. The firm behind the efforts, ID Quantique, is Swiss. The other two companies developing quantum cryptography for commercial use, MagiQ and BBN Technologies, are American. Employing quantum cryptography to transmit the vote from polling stations to central counting house is thus a bit of a publicity stunt.

Still, this will be the first time the technology has been deployed for real, so whether the system succeeds or fails will be of great importance to ID Quantique. Like the other two firms, it has its eyes on banks, insurance companies and other businesses that have to move a lot of sensitive data around. Whether the government of Florida will be interested is a different question.

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Evolution

The origin of speakies

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More evidence that Neanderthals could talk to each other

IF YOU found yourself in a cocktail bar with a Neanderthal man, what would he say? A good conversation is one of the great joys of being human, but it is not clear just how far back in the hominid lineage the ability to use language stretches. The question of when grunts and yelps turned into words and phrases is a tricky one. One way of trying to answer it is to look in the fossil record for evidence about what modern humanity's closest relatives could do.

Svante Pääbo, of the Max Planck Institute for Evolutionary Anthropology in Leipzig, and his colleagues have done just that. Dr Pääbo is an expert in extracting and interpreting the DNA of fossils. As he reports in the latest issue of *Current Biology*, he and his team have worked their magic on a gene called FOXP2 found in Neanderthal remains from northern Spain.

The reason for picking this particular gene is that it is the only one known so far to have a direct connection with speech. In 1990, a family with an inherited speech disorder known as verbal dyspraxia drew the attention of genetics researchers. Those researchers identified a mutation in FOXP2 as the cause of the dyspraxia.

Since then FOXP2 has been the subject of intensive study. It has been linked to the production of birdsong and the ultrasonic musings of mice. It is a conservative type, not changing much from species to species. But it has undergone two changes since humans split from chimpanzees 6m years ago, and some researchers believe these changes played a crucial role in the development of speech and language.

If these changes are common to modern humans and Neanderthals, they must predate the separation of the line leading to *Homo sapiens* from the one leading to *Homo neanderthalensis*. Dr Pääbo's research suggests precisely that: the FOXP2 genes from modern humans and Neanderthals are essentially the same. To the extent that the gene enables language, it enables (or enabled) it in both species.

There has been much speculation about Neanderthals' ability to speak. They were endowed with a hyoid bone, which anchors the tongue and allows a wide variety of movements of the larynx. Neanderthal skulls also show evidence of a large hypoglossal canal. This is the route taken by the nerves that supply the tongue. As such, it is a requisite for the exquisitely complex movements of speech. Moreover, the inner-ear structure of *Homo heidelbergensis*, an ancestor of Neanderthals, shows that this species was highly sensitive to the frequencies of sound that are associated with speech.

That Neanderthals also shared with moderns the single known genetic component of speech is another clue that they possessed the necessary apparatus for having a good natter. But suggestive as that is, the question remains open. FOXP2 is almost certainly not “the language gene”. Without doubt, it is involved in the control and regulation of the motions of speech, but whether it plays a role in the cognitive processes that must precede talking remains unclear—jokes about engaging brain before putting mouth in gear notwithstanding.

The idea that the forebears of modern humans could talk would scupper the notion that language was the force that created modern human culture—otherwise, why would they not have built civilisations? But it would make that chat with a Neanderthal much more interesting.

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The Soviet Union

Stalin's children

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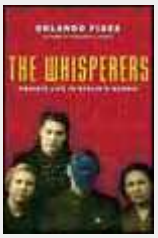
Tens of millions died in Stalin's famines, purges and camps. Most Soviet citizens somehow survived. Here are some of their stories

The Whisperers: Private Life in Stalin's Russia
By Orlando Figes



To be published in America in November by Metropolitan; $35
Allen Lane; 740 pages; £25.

Buy it at
Amazon.com
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ONE of Russia's most popular television shows is “Wait For Me”, a true-life tear-jerker that finds and reunites separated couples and families. Sometimes the stories it tells are run-of-the-mill melodramas that could have happened anywhere. But often they are tragically Russian, combining huge distances, lavish and indiscriminate cruelty and impenetrable bureaucracy: siblings separated 70 years ago when their parents were executed; lovers who lost one another in prison camps.

“Wait For Me” takes its name from the most famous Russian poem from the Soviet Union's war with Germany. Konstantin Simonov, its author, was part of the first generation to grow up with the Soviet system's mock classroom trials, playground games of “search and requisition”, and the “cult of struggle” inherited from the civil war. His aristocratic family was wrecked by the revolution; but like many children of undesirables, he disguised his background, transmuting the values he inherited into devout Stalinism.

Simonov wrote admiringly of the redemptive power of slave labour and the White Sea Canal, one of the

gigantic Stalinist infrastructure projects built on the skeletons of prisoners. But it was “Wait for Me” that brought him fame, a *dacha*, foreign travel and the affections of the actress (herself hiding a tainted biography) to whom the poem had presumptuously been addressed. He copied Stalin's pipe and moustache, and lent his voice to the dictator's post-war anti-Semitic purges. The torture and exile of relatives did not dislodge his faith; nor did Stalin's discombobulating death. Yet Simonov was also a brave war reporter, a generous friend and, eventually, conscience-stricken and remorseful.

His is the most prominent of the hundreds of lives described in “The Whisperers” by Orlando Figes, a professor of history at London University. The aim is to reconstruct “the inner world of ordinary Soviet citizens living under Stalin's tyranny”: to resuscitate, using letters, diaries and interviews (gathered partly by the heroic human-rights group Memorial) the human beings buried beneath the headline death tolls that dominate understanding of Stalinism, as they do the Holocaust. With his dissimulation and compensating zeal, his accommodations and rationalisations, his mix of motives (careerism, but also fear and genuine belief) and his proximity to the suffering he nevertheless condoned, Simonov provides exemplary answers to the questions that weave through the book. How did people survive Stalinism? And why did they go along with it?

This is an exhausting, even numbing encyclopedia of woe—characters miraculously survive one cataclysm only to perish in the next—made bearable by the compassion its subjects show one another and Mr Figes's own rigorously compassionate treatment of their compromises. For many readers, the section on the insane campaign against the *kulaks* (allegedly rich peasants) may be the most enlightening. It concentrates on the Golovin family from Obukhovo, a village renamed when the new serfdom of collectivisation arrived, the church bells taken away to be melted down as peasants ululate. Denounced by a drunk teenager, the Golovins are resettled a continent away in Augean conditions.

Also hitherto underchronicled is the grim struggle for housing in Stalin's newly overcrowded cities, where people married, stayed together and denounced each other for a few precious square metres of floor. Mr Figes relates the squalor and spying that prevailed in the *communalki*—communal apartments designed to erode families as well as to economise on space— in which millions of Russians once lived and a few still do.

After deaths from overwork and starvation, there is the plain mass murder of the 1937-38 terror: the sleepless nights spent waiting for the knock on the door; the bags kept by the bed in readiness for arrest. Again, the motives of the informers are mixed: grudges and envy, but also fear and blackmail. “Enemies of the people” confess because of torture or a desire to protect families (often killed or exiled anyway); but also, sometimes, out of a conviction that conniving in their own deaths will help the Party.

Then there is the carnage and heroism of the war and the wartime hopes of a better life, soon extinguished by yet more famine and repressions. Finally, Stalin dies—and, as the poet Anna Akhmatova put it, two Russias confronted each other: “the one that sent these people to the camps and the one that came back”.

There are incredible reunions in this book, achieved through impossible stamina and ingenuity. But there are also homecomings as terrible in their way as exile: parents who finally reclaim children from orphanages, but live out their relationships in stigma and silence, for ever hoarding food and quailing before policemen. Husbands and wives remarry, thinking their spouses are dead. Sometimes those left behind remain true believers; sometimes it is the returnees who still are. Some hide their pasts from families for decades, as the authorities obfuscate and lie to cover up the extent of their crimes.

It is perhaps a failing—though a fitting one—that people sometimes get lost in this book, disconcertingly reappearing after long gaps, just as they reappeared in reality after alienating absences. Some of Mr Figes's judgments are cursory. But this is a humbling monument to the evil and endurance of Russia's Soviet past and, implicitly, a guide to its present.

He writes of the “genetic fear” that percolates through generations, and the need to believe in bad rulers because the alternative, believing in nothing, could be worse. “Either they were guilty”, Simonov says of Stalin's victims, “or it was impossible to understand.” The terror, Mr Figes notes, “tore apart the moral ties that hold together a society.” It is still recovering.

The Whisperers: Private Life in Stalin's Russia.
By Orlando Figes.
Allen Lane; 740 pages; £25.
To be published in America in November by Metropolitan; $35

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Memoirs

Minus the airbrushing

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THE first volume of Arthur Schlesinger's memoirs, covering the years 1917-50, was published in 2000. Reviewing it, this paper suggested that if his second volume matched his first, Mr Schlesinger would have produced the 20th-century counterpart to Henry Adams's classic autobiography of a 19th-century intellectual. But the memoir-writer died last February so that prediction cannot be tested. Instead his contemporaneous typewritten journals have now been published, abridged but not expurgated.

Though an imperfect substitute for a reflective integrated work, the "Journals" are an indispensable source for historians—and irresistibly readable. Schlesinger worked for or advised every Democratic president and nominee since Adlai Stevenson (with the exception of Jimmy Carter). Enjoying a hyperactive social life, his eclectic circle included Isaiah Berlin, Marlene Dietrich, Arthur Koestler, Harold Pinter, Elizabeth Taylor, Gore Vidal and Mick Jagger. Brilliant *aperçus*, memorable quotations and titillating gossip fill his notes.

Journals: 1952-2000
By Arthur M. Schlesinger junior

Penguin Press; 958 pages; $40

Buy it at
Amazon.com
Amazon.co.uk

Discussing Richard Nixon's practice of secretly taping conversations, Schlesinger, as a person, thinks it a poor idea but as a historian regards it as a fine way to enrich the record. In a way, the "Journals" are the equivalent of uncensored tapes, revealing incidents that might have been air-brushed from the projected memoir.

Often accused, with some justification, of being a court historian, Schlesinger nonetheless records the flaws of men he greatly admired. For instance John Kennedy explained, shortly before sending American-trained Cuban exiles ashore at the Bay of Pigs: "If we have to get rid of those 800 men, it is much better to dump them in Cuba than in the United States." And he observes that Stevenson did not feel that any strong moral issue was involved in the civil-rights struggle—and sympathised more with Southern whites than with Southern blacks.

Al Gore is captured telling a disappointed hopeful for the post of UN ambassador that the nominee would be the less well-qualified Madeleine Albright. He opens the conversation by asking: "Have you considered a sex change?" Henry Kissinger is reported as describing Donald Rumsfeld as "the rottenest person he had known in government". More unexpected, in view of the Camelot legend, when Schlesinger in early 1960 asked Kennedy to compare his appeal with that of Hubert Humphrey, his rival for the Democratic nomination, JFK said there were no great policy issues between them but that what the electorate wanted was "a more boring, monotonous personality, like me".

Because of the disjointed nature of diaries, gems turn up unexpectedly. During a period of comparative optimism on the Middle East, Abba Eban observes: "There is a tunnel at the end of the light." And Brooke Astor, a New York socialite who died this year, discusses Bill Clinton's affair with a "floozy": "Why couldn't he have stayed with someone of his own class?"

Schlesinger skewers his opponents with relish. His college classmate and Reagan's secretary of defence, Casper Weinberger, explains "everything with the placid certitude and quiet lucidity of a madman". Over 20 years ago, Schlesinger had a debate with Charles Krauthammer, a conservative writer, who urged the need for an imperial policy and unfettered presidential secrecy. Schlesinger observed that "he argues this line with boundless self-righteousness and sublime ignorance of American history". Mr Krauthammer's position remains unchanged.

Schlesinger could be off the mark. He saw no signs of the economic collapse of the Soviet Union and after meeting Boris Yeltsin in 1989 concluded that he was "certainly no alternative to Gorbachev". Mainly, however, Schlesinger's judgments are sound and many remain instructive. In 1967 he found it hard to

see how Congress could restrain a presidential drive towards enlarging the Vietnam war and recognised that voting against military appropriations was both humanly and politically self-defeating. In 1983 he felt that perhaps he was getting tired and cynical, but he despaired of America's capacity “to go into other countries and set things straight”. Discussing a matter of some current interest, after initial scepticism he came to agree with Jacqueline Kennedy that Hillary Clinton, despite the public impression of severity she projected, “has an excellent sense of humour and is great fun.”

Journals: 1952-2000
By Arthur M. Schlesinger junior
Penguin Press; 958 pages; $40

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Ireland

Top of the morning

Oct 18th 2007
From The Economist print edition

IT IS over now and a lot of Irish people, gazing out of the windows of their brand-new houses, still cannot believe it happened. A country that long prided itself on being uniquely oppressed is rich. For 15 years Ireland's economy grew by 7% or more a year and the results show everywhere: as ugly bungalows, seedy politics, polluted rivers, Polish plumbers and a huge increase in welfare for rich and poor alike. Roy Foster, grandmaster of Irish history (including a brilliant little book "Modern Ireland, 1600-1972"), brings the story almost up to date.

Luck & the Irish: A Brief History of Change 1970-2000
By R.F. Foster

Allen Lane; 228 pages; £20.
To be published in America by Oxford University Press in February; $30

Buy it at
Amazon.com
Amazon.co.uk

At the start of the 1970s, half a century after its part of the island achieved independence, Ireland joined the European Economic Community (as the European Union was then called). Subsidies flowed in from Brussels. American investors loved an English-speaking location with pliable politicians and low corporate tax where the profits on their European operations could be transferred. As Mr Foster nicely puts it: "A certain amount of good luck was maximised by good management."

A wholly centralised government, with wholly unideological politics, skilfully marketed its business-friendliness, which was fertilised (as the proceedings of Dublin's interminable tribunals of inquiry are, amid loud tut-tuttings, still revealing) by cash in brown envelopes, handed over with a nod and a smile. Between 1979 and 1996 the late Charles Haughey, leader of the dominant party and prime minister for most of the time, took €11.56m (equivalent, the book says, to €45m or $64m in today's currency) in payments for favours. Donors were rewarded with building contracts, tax concessions and relaxed zoning regulations, all of which did the growth rate no end of good.

The trouble in Northern Ireland helped too. America's Democratic parishes rallied round, and the European partners imposed their rules lightly (the British, anxious for good relations, were especially forgiving). Meanwhile the economy was swiftly absorbing underused labour from three main sources: farms, tiny and belatedly mechanised, gave up their young, the diaspora came home and, above all, women started going out to work. Just in time, the education system was strengthened and expanded. And when the talent ran out immigrants arrived, to bring extra vim not only to the building trades but, because lots of them are Polish, to Ireland's fading Roman Catholic church.

Mr Foster goes through this with acerbic thoroughness. Since the book is shortish and the twists and turns frequent, the narrative is sometimes too quick for the comfort of readers who did not live through its times. Readers should know before they start which is Ray Burke and which Ray MacSharry, and why a fragment of the IRA is Official and most of it Provisional.

It is salutary to be reminded just how foul a little war was waged in Northern Ireland, and how quickly ex-terrorists were installed as the queen's ministers in Belfast. In 1986 the rebels (in the person of Martin McGuinness, now one of those ministers) formally renounced their central contention, recognising that there were two governments in Ireland and that the one in Dublin legitimately ruled an Irish state. Twenty years later his Sinn Fein party took a dive in the south's general election; the people had swapped their all-Ireland dream for pride that the republic was now richer than the north.

Ireland these years produces poets and novelists at the same rate as hideous bungalows. But how good are they? "The Gathering", a novel by Anne Enright, won the Booker prize this week (see article). The author makes large claims which need defending in more detail than this small book has room for.

Mass-market music, though, gets due attention. Whatever one may think of the songs, the world-wide success of Irish rock bands is a strange and wonderful phenomenon, made stranger still by the anti-

poverty evangelism so vigorously pushed by Bob Geldof and his more popular imitator, Bono. Mr Foster has the courage, and the historian's skill, to tackle all this stuff, make sense of most of it and entertain his readers too.

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Ezra Pound

A solitary volcano

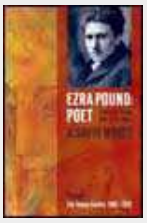
Oct 18th 2007
From The Economist print edition

“WHANG—Boom—Boom—cast delicacy to the winds.” Thus Ezra Pound in a letter to his father, urging the old man to help promote his first published collection. It might have been the poet's manifesto.

Pound is as divisive a figure today as he was in his own lifetime. For some he was the leading figure of the Modernist movement who redefined what poetry was and could be; and who, in his role as cultural impresario, gave vital impetus to the literary careers of T.S. Eliot, James Joyce and Wyndham Lewis, among others. But for many Pound remains a freak and an embarrassment, a clinical nutcase and vicious anti-Semite who churned out a lot of impenetrable tosh before losing the plot completely.

During the second world war he broadcast pro-Fascist radio programmes from Italy and later avoided trial for treason at home only because he was declared insane. On his release from St Elizabeth's Hospital near Washington, DC, he returned to Italy (“America is a lunatic asylum”), where he died in 1972 aged 87.

Ezra Pound: Poet: The Young Genius 1885-1920
By A. David Moody



Oxford University Press; 544 pages; £25. To be published in America in December; $47.95

Buy it at
Amazon.com
Amazon.co.uk

David Moody, emeritus professor of English at York University, makes a strong case for Pound's “generous energy” and the “disruptive, regenerative force of his genius”. His approach (unlike Pound's) is uncontroversial. He follows the poet's progress chronologically from his childhood in Idaho—still, at the time of his birth in 1885, part of the wild west—to his conquest of literary London between 1908 and 1920. He marshals Pound's staggering output of poetry, prose and correspondence to excellent effect, and offers clear, perceptive commentary on it. He helps us to see poems, such as this famous, peculiarly haunting 19-syllable haiku, in a new light:

> The apparition of these faces in the crowd:
> Petals on a wet, black bough.

That Mr Moody is constantly being upstaged by the subject of his study is not surprising. Pound was one of the most colourful artistic figures in a period full of them.

According to Ford Madox Ford, who became a good friend of Pound's shortly after the bumptious young American arrived in London: “Ezra would approach with the step of a dancer, making passes with a cane at an imaginary opponent. He would wear trousers made of green billiard cloth, a pink coat, a blue shirt, a tie hand-painted by a Japanese friend, an immense sombrero, a flaming beard cut to a point and a single large blue earring.” W.B. Yeats's simple assessment was that: “There is no younger generation of poets. E.P. is a solitary volcano.”

A great merit of Mr Moody's approach is the space he gives to Pound's writings. It is love-it-or-hate-it stuff, but, either way, undeniably fascinating. “All good art is realism of one kind or another,” Pound said. Reconciling that tidy statement with practically any of his poems is hard work but, as Mr Moody shows over and over again, hard work that offers huge rewards.

His first volume ends in 1920, with Pound quitting London in a huff, finally fed up—after more than a decade of doing everything in his power to rattle the intellectual establishment—with “British insensitivity to, and irritation with, mental agility in any and every form”. His disgraceful radio programmes and the full blooming of his loopiness lie ahead. So, too, do most of his exquisite Cantos.

Ezra Pound: Poet: The Young Genius 1885-1920.
By A. David Moody
Oxford University Press; 544 pages; £25. To be published in America in December; $47.95

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Art fairs

Satellites around the sun

Oct 18th 2007
From The Economist print edition

Special exhibitions, of one kind or another, are ringing the official fairs

ART and antiques fairs are springing up everywhere: in a six-month period, three new ones popped up in Shanghai alone. “People don't gallery shop as they used to,” explains Anna Haughton, a London ceramics dealer who with her husband has organised the International Fine Art and Antique Dealers Show, now in its 19th year, which is open from October 19th to 25th at New York's Park Avenue Armory. The spending spree on works of art goes beyond the official fairs, which nowadays increasingly attract satellites, or special exhibitions, into their orbit. “If you get this huge proliferation, the quality is going to go down,” suggests Mrs Haughton. Perhaps, but to judge by all the frenetic activity going on, the demon unleashed is more likely to be exhaustion.

Take, for example, the four smaller contemporary art fairs that were timed to coincide with the opening of London's fifth Frieze Art Fair, held this month in an enormous tent in Regent's Park. As well as the fairs, Christie's and Sotheby's staged big sales of contemporary art. New or newly refurbished galleries were launched. And fashion people, including Mulberry and Bella Freud, held special shows.

Brunetti

Joseph's dream from the abbey at St. Denis

With contemporary art the hottest corner of the current market, it is not surprising that big contemporary art fairs like Frieze, Art Basel and Art Basel Miami attract crowds of international collectors, museum curators and satellites. But the grand traditional fairs, such as the Biennale des Antiquaires in Paris, are also ringed by related auctions, museum events and special shows.

New York's international fair has over 60 exhibitors showing antiquities, furniture, porcelain, armour and paintings. At the same time, the satellites are laying out their wares. Several well-known dealers are mounting big exhibitions in private galleries. At the Alexander Gallery, Sam Fogg comes from London with his “Art of the Middle Ages”, including a long lost, 12th-century stained-glass panel from the abbey at St Denis near Paris. And Anthony Blumka (together with Munich's Florian Eitle-Böhler) offers 55 medieval, Renaissance and baroque pieces in an exhibition called “Collecting Treasures” at his Upper East Side premises.

The dealers explain that they have much more space at private galleries than in the relatively squashed conditions of the fair. But Jamie Ede, a London dealer, prefers the official fairs because they attract new clients and “create an overall buzz”. This buzz reverberates through the city. Visitors to the fair can stroll over to the Metropolitan Museum of Art to see “Tapestry in the Baroque” which opens on October 23rd. Then the newly refurbished Wrightsman Galleries for French Decorative Arts reopen the following week. And on October 25th and 26th Sotheby's is selling the entire stock of Ariane Dandois's recently closed Paris gallery.

Might the satellites take visitors away from the fairs and die themselves as a result? Amanda Sharp, co-founder and director of Frieze thinks not. “We welcome people doing good things...I don't see that in any way these satellites eclipse the sun.” Yet a larger eclipse is feared. At the fairs these days, gossip soon turns to the state of the market and the huge prices being paid for works of art, from Hong Kong to New York. The question is becoming not if but when that bubble will burst.

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The Man Booker prize

Lust in the old country

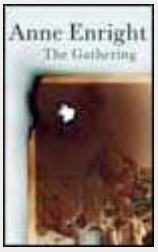
Oct 18th 2007
From The Economist print edition

IN 2004 the judges of the Man Booker prize passed up the chance to honour the sprawling, drunken family as one of the finest pieces of theatre that literature has to offer when it picked Alan Hollinghurst's “The Line of Beauty” over Gerard Woodward's “I'll Go to Bed at Noon”. This week a new panel unexpectedly gave fiction's best-known award to Anne Enright for “The Gathering”, a raw examination of a family (Irish, of course) made up of 12 children, seven miscarriages and more than a lifetime of drink, masturbation and misery.

In making their choice, the judges turned their backs on three more interesting offerings: Ian McEwan's “On Chesil Beach”, one of the year's biggest sellers; Mohsin Hamid's “The Reluctant Fundamentalist”, a fine examination of America's fear of Islam; and an engaging and original study of the power that literature has to change lives irrevocably (Lloyd Jones's “Mister Pip”).

Not that “The Gathering” is without its strengths. Ms Enright, the fourth Irish writer to win the prize, is a 45-year-old Dubliner who has written three previous novels, short stories and a work of non-fiction. She has a fine writing voice and is good at melding raw anger with an original and funny turn of phrase.

The Gathering
By Anne Enright



Grove Press /Black Cat; $14.
Jonathan Cape; 261 pages; £12.99

Buy it at
Amazon.com
Amazon.co.uk

At the start of the book, the by-now adult Hegarty children descend on the Irish family home after one of their brothers, Liam, drowns himself in Brighton, having first taken care to remove his dirty socks and underpants, and fill his pockets with stones. In their grief, his siblings look more intently at their past.

Inevitably the family includes one good sister and one bad, a fallen priest and a rich brother who tries to keep his distance from the mess. There are stories of shared beds (probable with 12 children in the house) and a lot of sex. It is this sexual tension, or the tension of unrepressed male lust to be specific, that fuels the book's anger and drives forward the narrative.

But in the end there is only so much to be learned about fumbling priapic landlords and the stale smell of liquor. For a book that leads with the heart or the brain, rather than the penis, try one of the others on the shortlist instead.

The Gathering
By Anne Enright.
Jonathan Cape; 261 pages; £12.99
Grove Press/Black Cat; $14.

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Bob Denard

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From The Economist print edition

Bob Denard, mercenary and coup-master, died on October 13th, aged 78

Topfoto

THERE were usually several versions of any story involving Bob Denard. To explain how he came to be found, in the early hours of November 26th 1989, standing over the blood-soaked and pyjama-clad body of the president of the Comoros Islands, there were three alternatives. One: Mr Denard had shot him. (He denied it in court; though he had been in the same room, and very close to him, he had not pulled the trigger.) Two: the palace bodyguard had burst in wildly, filling the president with bullets. ("Inexplicable," Mr Denard agreed, but true; "an accident arising out of a general state of madness.") Or perhaps—mad theory three—an army commandant had fired off an anti-tank missile by mistake, which had crashed through the window of the presidential bedroom.

The French courts never worked it out, and in 1999 acquitted Mr Denard for lack of evidence. His long dark history as a mercenary in Africa, from 1961 onwards, had blurred everything about him. His name was Bob Denard, or Gilbert Bourgeaud, or Colonel Bako, or Mustafa M'hadjou. The wound that made him limp had come from a bullet in Congo, or perhaps in Algeria. His fascination with all things military sprang from a boyhood in the French resistance in the Médoc, or alternatively from his first entranced sighting of the shiny helmets, boots and guns of the German troops invading his village. He had been cashiered from the French navy, at 16, for running riot in a Saigon whorehouse or for burning down a restaurant. Fact or fiction: few knew for sure.

Mr Denard could look gentlemanly, smart in grey suits or his spurious colonel's uniform. He thought the word "mercenary" insulting and torture "repugnant". Visitors to his beach house in the Comoros might find him, surrounded by his children from seven different pretty women, sipping tea under a frangipani tree. Dom Perignon and *paté de foie gras* would be shipped out after him when his plots failed. But he was also a brawny, flamboyant soldier in camouflage fatigues, leader of "les affreux" ("the terrible ones") in the Congo—in fact, *le plus affreux des affreux*, as he boasted to his men. He did a job in which killing was necessary, sometimes alongside underlings who stubbed out their cigarettes on prisoners' feet or roughly removed their teeth and eyes.

Money was an attraction. When he could, he built up business interests on the side. But he said he could earn more pay as an ordinary soldier; his stronger motives were adventure, "idealism", and the fact that he was stifling in Paris, "bored shitless", if he didn't make war somewhere. He fought in cold-war Africa for anti-communist rulers favoured by the West, and for any regime that would help the French, as they let go their colonies, to keep their investments safe and their influence alive.

In breakaway Katanga in the 1960s Mr Denard propped up Moishe Tshombe, a creature of Belgian mining interests in Congo, against a United Nations force. He tried to launch coups in Yemen and Benin and

fought for secession in Biafra. His men—usually only a few dozen of them—were generally French, Belgian or South African, well equipped with guns and armoured jeeps, whipping the untrained blacks into shape. Mr Denard himself seemed less racist than his troops, and in the Comoros, having converted to Islam, he wore the robes and cap of a native as he limped to Friday prayers. But he laughed at the thought of democracy in Africa.

An amber light

At certain times his presence was benevolent. In 1964 he and his men saved the whites of the town of Stanleyville, in Congo, from being slaughtered by a drug-crazed mob. His coup in the Comoros in 1978, one of four he engineered in the archipelago between 1975 and 1995, brought in a decade of relative stability while he took charge of the army and the economy and his Garde Presidentielle, their food and black uniforms paid for by South African money, guarded the puppet ruler. He once claimed to be acting in the higher interests of civilisation. Frederick Forsyth, in “The Dogs of War”, may have borrowed from the glamour of his character.

Yet amateurism often dogged his enterprises. Invasions were launched from rusty trawlers and inflatable dinghies and once, in Congo, on bicycles. He crashed in flames more often than he succeeded. If the South Africans did not pull him out to the safety of suburban Pretoria, a French expeditionary force, shiny and efficient, sometimes arrived to remove him before he went too far. On his last coup attempt in the Comoros, in 1995 at the age of 66, his grandfatherly arm was taken gently by French officers before he was led away to face yet more criminal investigations.

A conviction followed in 2006, but no punishment. By this time Mr Denard was ill with Alzheimer's, but there was another reason. De Gaulle's spymaster, Jacques Foccart, had first recruited him for Africa. Subsequent officials at the Elysée had provided money and passports. Asked during one trial whether he had had a green light from the government for his plots, he said no, not exactly; just an amber light, meaning that there was no opposition. He was, he liked to say, a “corsair of the Republic”, implicitly given permission to proceed with dash and without compunction. And so he did.

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Overview

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Consumer prices in **America** rose by 0.3% in September, to stand 2.8% higher than a year earlier. The core measure, which excludes food and energy, rose by 2.1% in the year to September. Industrial production rose by 0.1% in the month and by 1.9% compared with a year before.

America's **housing market** continues to weaken and vendors remain gloomy about the outlook. The National Association of Home Builders index of expected sales for new single-family homes fell to the lowest level since the series began in January 1985. Housing starts fell by 10.2% in September following a 3.2% drop in August.

Industrial production in the **euro area** rose by 1.2% in August, leaving it 4.3% higher than in August 2006.

In **Britain**, consumer prices rose by 1.8% in the year to September, the same rate as in August. The central bank's Monetary Policy Committee discussed the case for an interest-rate cut this month, according to the minutes of its two-day meeting. But just one of its nine members voted for a reduction.

The Bank of **Canada** left its benchmark interest rate at 4.5%. The bank cut its GDP growth forecast for next year from 2.6% to 2.3%.

Turkey's central bank cut its overnight lending rate by 0.75 percentage points to 21.5% and its overnight borrowing rate by 0.5 percentage points to 16.75%. The bank thinks that even after these reductions, short-term interest rates are “restrictive”.

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Output, prices and jobs

Oct 18th 2007
From The Economist print edition

Output, prices and jobs

% change on year ago

	Gross domestic product				Industrial production	Consumer prices			Unemployment
	latest	qtr*	2007†	2008†	latest	latest	year ago	2007†	rate‡, %
United States	+1.9 Q2	+3.8	+2.0	+2.2	+1.9 Sep	+2.8 Sep	+2.1	+2.8	4.7 Sep
Japan	+1.6 Q2	−1.2	+2.0	+1.9	+4.3 Aug	−0.2 Aug	+0.9	nil	3.8 Aug
China	+11.5 Q2	na	+11.5	+10.0	+17.5 Aug	+6.2 Sep	+1.5	+4.5	9.5 2006
Britain	+3.1 Q2	+3.3	+2.9	+2.1	+0.7 Aug	+1.8 Sep**	+2.4	+2.3	5.4 Jul††
Canada	+2.5 Q2	+3.6	+2.5	+2.5	−0.5 Jul	+1.7 Aug	+2.1	+2.2	5.9 Sep
Euro area	+2.5 Q2	+1.3	+2.6	+2.1	+4.3 Aug	+2.1 Sep	+1.7	+2.0	6.9 Aug
Austria	+3.5 Q2	+3.5	+3.2	+2.6	+5.3 Jul	+2.1 Sep	+1.4	+1.8	4.2 Sep
Belgium	+2.9 Q2	+2.5	+2.6	+2.1	+4.1 Aug	+1.5 Sep	+1.2	+1.7	11.4 Sep‡‡
France	+1.3 Q2	+1.2	+1.8	+2.0	+2.6 Aug	+1.5 Sep	+1.2	+1.4	8.0 Jul
Germany	+2.5 Q2	+1.0	+2.7	+2.2	+5.2 Aug	+2.5 Sep	+1.0	+2.0	8.8 Sep
Greece	+4.1 Q2	na	+3.8	+3.2	−0.4 Aug	+2.9 Sep	+2.9	+2.6	8.4 Jun
Italy	+1.8 Q2	+0.5	+1.8	+1.5	+3.0 Aug	+1.7 Sep	+2.1	+1.9	6.0 Q2
Netherlands	+2.6 Q2	+1.2	+2.5	+2.2	+2.2 Aug	+1.3 Sep	+1.3	+1.6	4.4 Sep††
Spain	+4.0 Q2	+3.8	+3.7	+2.7	+0.6 Aug	+2.7 Sep	+2.9	+2.7	8.0 Aug
Czech Republic	+6.0 Q2	+5.7	+5.6	+3.0	+5.5 Aug	+2.8 Sep	+2.7	+2.6	6.2 Sep
Denmark	+0.6 Q2	−1.6	+1.7	+1.8	−1.4 Aug	+1.2 Sep	+1.5	+1.7	3.3 Aug
Hungary	+1.2 Q2	+0.2	+2.1	+3.0	+12.2 Aug	+6.4 Sep	+5.9	+7.8	7.2 Aug††
Norway	+3.9 Q2	+3.5	+3.1	+2.6	−0.6 Aug	−0.3 Sep	+2.6	+0.8	2.5 Aug††
Poland	+6.7 Q2	na	+6.5	+5.1	+9.0 Aug	+2.3 Sep	+1.6	+2.3	12.0 Aug‡‡
Russia	+7.8 Q2	na	+7.2	+6.4	+3.0 Sep	+9.5 Sep	+9.5	+8.3	5.7 Aug‡‡
Sweden	+3.5 Q2	+3.7	+3.4	+3.0	+2.4 Aug	+2.2 Sep	+1.5	+1.8	4.2 Sep‡‡
Switzerland	+2.8 Q2	+3.0	+2.6	+2.1	+9.8 Q2	+0.7 Sep	+0.8	+0.7	2.5 Sep‡‡
Turkey	+3.9 Q2	na	+5.2	+5.2	+6.1 Aug	+7.1 Sep	+10.6	+8.5	8.9 Q2‡‡
Australia	+4.3 Q2	+3.8	+4.1	+3.5	+4.6 Q2	+2.1 Q2	+4.0	+2.4	4.2 Sep
Hong Kong	+6.9 Q2	+8.2	+6.2	+5.2	−2.3 Q2	+1.6 Aug	+2.5	+1.9	4.1 Sep††
India	+9.3 Q2	na	+8.0	+7.9	+10.7 Aug	+7.3 Aug	+6.3	+5.9	7.6 2006
Indonesia	+6.3 Q2	na	+6.3	+6.4	+4.3 Aug	+7.0 Sep	+14.5	+6.1	9.8 Feb
Malaysia	+5.7 Q2	na	+6.0	+5.8	+0.9 Aug	+1.9 Aug	+3.3	+2.1	3.4 Q2
Pakistan	+7.0 2007§§	na	+6.4	+5.9	+6.3 Jul	+8.4 Sep	+8.7	+6.7	6.2 2006††
Singapore	+9.4 Q3	+6.4	+7.0	+5.1	+13.8 Aug	+2.9 Aug	+0.7	+1.2	2.4 Q2
South Korea	+5.0 Q2	+7.4	+4.9	+5.2	+11.2 Aug	+2.3 Sep	+2.5	+2.3	3.2 Sep
Taiwan	+5.1 Q2	na	+4.3	+4.6	+10.2 Aug	+3.1 Sep	−1.2	+1.0	3.9 Aug
Thailand	+4.4 Q2	+5.2	+4.6	+5.0	+10.2 Aug	+2.1 Sep	+2.7	+2.0	1.2 Jul
Argentina	+8.7 Q2	+8.8	+7.7	+5.7	+0.1 Aug	+8.6 Sep	+10.4	+8.6	8.5 Q2‡‡
Brazil	+5.4 Q2	+3.2	+4.7	+4.5	+6.5 Aug	+4.1 Sep	+3.7	+3.7	9.5 Aug‡‡
Chile	+6.1 Q2	+6.5	+6.1	+5.1	+4.0 Aug	+5.8 Sep	+2.8	+3.7	7.6 Aug††††
Colombia	+6.9 Q2	+4.4	+6.6	+5.8	+12.3 Jul	+5.0 Sep	+4.6	+5.6	10.6 Aug‡‡
Mexico	+2.8 Q2	+5.3	+2.8	+3.1	+2.6 Aug	+3.8 Sep	+4.1	+4.0	3.9 Aug‡‡
Venezuela	+8.9 Q2	na	+6.5	+4.9	+14.1 Jul	+15.3 Sep	+15.3	+18.1	8.4 Q2‡‡
Egypt	+7.4 Q1	na	+7.0	+7.3	+10.5 2006	+8.5 Aug	+8.9	+8.4	9.0 Q1‡‡
Israel	+4.4 Q2	+6.1	+5.0	+4.5	+3.1 Jul	+1.4 Sep	+1.3	+0.5	7.6 Q2
Saudi Arabia	+4.3 2006§	na	+4.8	+5.6	na	+4.4 Aug	+1.6	+3.4	na
South Africa	+5.0 Q2	+4.5	+4.8	+5.1	+5.1 Aug	+6.7 Aug	+5.4	+6.0	25.5 Mar‡‡
MORE COUNTRIES Data for the countries below are not provided in printed editions of *The Economist*									
Estonia	+7.6 Q2	na	+7.9	+5.8	+4.4 Aug	+7.2 Sep	+3.8	+6.0	5.5 Aug
Finland	+4.7 Q2	+3.8	+4.4	+2.7	−0.3 Aug	+2.6 Sep	+1.5	+2.7	6.9 Aug
Iceland	+2.5 Q2	+9.1	+1.2	+1.6	+7.6 2006	+4.5 Oct	+7.2	+4.8	0.9 Aug‡‡
Ireland	+5.4 Q2	−5.5	+4.7	+3.5	+10.0 Aug	+4.6 Sep	+4.0	+4.7	4.7 Sep
Latvia	+11.1 Q2	na	+9.6	+7.5	+3.0 Aug	+11.4 Sep	+6.0	+8.8	5.5 Aug
Lithuania	+8.0 Q2	+8.2	+7.8	+6.9	na	+7.1 Sep	+3.2	+5.0	2.8 Sep
Luxembourg	+5.3 Q2	+5.3	+5.0	+3.4	−1.0 Jul	+2.1 Sep	+2.4	+2.1	4.2 Aug‡‡
New Zealand	+3.8 Q2	+3.4	+3.0	+3.0	nil Q1	+1.8 Q3	+3.5	+2.4	3.6 Q2
Peru	+6.5 Aug	na	+7.3	+6.3	+7.0 Aug	+2.8 Sep	+2.0	+1.5	8.0 Aug‡‡
Philippines	+7.5 Q2	+7.1	+6.0	+5.6	+0.6 Jul	+2.7 Sep	+5.7	+2.8	7.8 Q3‡‡
Portugal	+1.6 Q2	+1.9	+1.8	+2.1	+1.0 Aug	+2.1 Sep	+3.0	+2.4	7.9 Q2‡‡
Slovakia	+9.4 Q2	na	+8.0	+6.0	+5.7 Aug	+2.8 Sep	+4.6	+2.7	8.2 Aug
Slovenia	+5.9 Q2	na	+5.6	+4.6	+10.1 Aug	+3.5 Sep	+2.5	+3.0	7.4 Aug‡‡

*% change on previous quarter, annual rate. †*The Economist* poll or Economist Intelligence Unit estimate/forecast. ‡National definitions. §RPI inflation rate 4.1% in Aug. **Year ending June. ††Latest three months. ‡‡Not seasonally adjusted.

Sources: National statistics offices and central banks; Thomson Datastream; Reuters; Centre for Monitoring Indian Economy; OECD; ECB

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The Economist commodity-price index

Oct 18th 2007
From The Economist print edition

The Economist commodity-price index

2000=100

	Oct 9th	Oct 16th*	% change on one month	% change on one year
Dollar index				
All items	213.2	215.5	+2.9	+16.7
Food	192.0	193.6	−0.2	+31.4
Industrials				
All	240.8	243.8	+6.3	+4.7
Nfa†	165.7	165.6	+2.3	+19.0
Metals	281.7	286.5	+7.6	+0.9
Sterling index				
All items	159.0	160.8	+1.1	+7.4
Euro index				
All items	140.0	140.8	+0.8	+3.4
Gold				
$ per oz	737.80	758.60	+6.1	+29.1
West Texas Intermediate				
$ per barrel	80.26	87.47	+6.6	+48.6

*Provisional †Non-food agriculturals.

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Transnational companies

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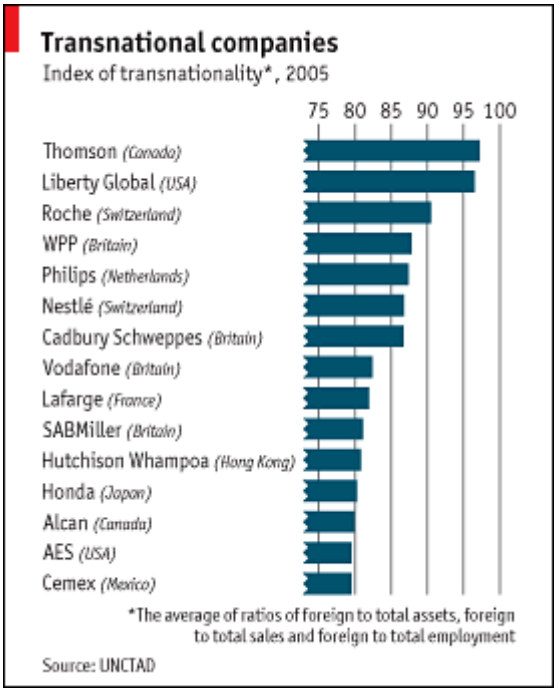
From The Economist print edition

Thomson, a media company, is the world's most transnational firm, according to the 2007 *World Development Report* from the United Nations Conference on Trade and Development (UNCTAD). The report's index of transnationality is calculated using the average of the shares of a firm's assets, sales and employment located abroad. Thomson has 97.8% of its assets, 96.6% of its sales and 97.3% of its jobs outside its Canadian homeland. Many of the top transnational firms are from small but rich countries, such as Switzerland, with limited domestic markets. Two notable exceptions are Liberty Global, an American telecoms company, ranked second in the study, and Honda, a Japanese carmaker.



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Trade, exchange rates, budget balances and interest rates

Oct 18th 2007
From The Economist print edition

Trade, exchange rates, budget balances and interest rates

	Trade balance* latest 12 months, $bn	Current-account balance latest 12 months, $bn	Current-account balance % of GDP 2007†	Currency units, per $ Oct 17th	Currency units, per $ year ago	Budget balance % of GDP 2007†	Interest rates, % 3-month latest	Interest rates, % 10-year gov't bonds, latest
United States	−810.7 Aug	−793.2 Q2	−5.6	–	–	−1.5	4.72	4.54
Japan	+98.1 Aug	+197.5 Aug	+4.6	117	119	−2.6	0.73	1.65
China	+253.4 Sep	+249.9 2006	+10.7	7.52	7.91	0.2	3.87	4.77
Britain	−160.4 Aug	−86.6 Q2	−3.2	0.49	0.54	−2.7	6.25	5.06
Canada	+48.5 Aug	+21.9 Q2	+1.8	0.97	1.14	0.6	3.92	4.41
Euro area	+29.2 Jul	+11.2 Jul	+0.2	0.70	0.80	−0.7	4.66	4.39
Austria	+1.2 Jul	+12.3 Q2	+2.9	0.70	0.80	−0.5	4.66	4.48
Belgium	+17.6 Aug	+14.4 Jun	+2.2	0.70	0.80	−0.1	4.72	4.51
France	−40.8 Aug	−25.8 Aug	−1.2	0.70	0.80	−2.4	4.66	4.48
Germany	+253.1 Aug	+196.9 Aug	+5.4	0.70	0.80	−0.4	4.66	4.38
Greece	−50.5 Jul	−36.7 Jul	−10.5	0.70	0.80	−2.4	4.66	4.66
Italy	−16.3 Jul	−49.4 Jul	−2.4	0.70	0.80	−2.5	4.66	4.64
Netherlands	+49.9 Aug	+53.5 Q2	+7.9	0.70	0.80	−0.6	4.66	4.47
Spain	−123.8 Jul	−125.1 Jul	−9.0	0.70	0.80	1.7	4.66	4.47
Czech Republic	+3.1 Aug	−5.9 Aug	−3.8	19.4	22.6	−4.0	3.56	4.57
Denmark	+4.2 Aug	+4.3 Aug	+1.5	5.25	5.96	3.8	4.90	4.48
Hungary	−1.7 Aug	−6.8 Q2	−5.2	177	213	−6.0	7.41	6.58
Norway	+54.5 Sep	+54.6 Q2	+14.2	5.40	6.78	18.9	5.59	5.00
Poland	−10.8 Jul	−14.6 Aug	−3.3	2.61	3.11	−2.2	5.14	5.78
Russia	+120.5 Aug	+73.5 Q3	+5.5	24.9	27.0	4.0	10.00	6.34
Sweden	+18.1 Aug	+29.7 Q2	+6.9	6.45	7.40	2.4	3.74	4.37
Switzerland	+11.1 Sep	+98.4 Q2	+16.4	1.18	1.27	0.3	2.79	2.99
Turkey	−56.4 Aug	−33.2 Aug	−7.3	1.21	1.47	−2.9	17.46	7.00§
Australia	−13.0 Aug	−47.1 Q2	−5.7	1.12	1.33	1.4	6.90	6.23
Hong Kong	−20.6 Aug	+25.3 Q2	+10.9	7.75	7.78	1.8	5.45	4.12
India	−70.7 Aug	−9.7 Q2	−1.6	39.5	45.4	−3.3	6.96	8.35
Indonesia	+41.7 Aug	+11.1 Q2	+2.3	9,095	9,158	−1.7	8.17	6.41§
Malaysia	+28.7 Aug	+27.6 Q2	+13.8	3.38	3.67	−3.2	3.62	4.99§
Pakistan	−13.8 Sep	−7.1 Q2	−4.5	60.6	60.6	−4.6	9.32	7.97§
Singapore	+38.5 Sep	+41.6 Q2	+25.7	1.46	1.58	0.3	2.50	2.84
South Korea	+20.1 Sep	+8.1 Aug	+0.4	918	955	0.5	5.34	5.49
Taiwan	+14.6 Sep	+28.3 Q2	+6.3	32.6	33.2	−2.0	2.60	2.82
Thailand	+10.2 Aug	+10.9 Aug	+3.5	34.2	37.4	−1.9	3.55	4.42
Argentina	+10.2 Aug	+7.4 Q2	+3.5	3.16	3.10	1.5	12.94	na
Brazil	+43.1 Sep	+10.6 Aug	+0.7	1.81	2.13	−1.8	11.18	6.16§
Chile	+24.1 Sep	+8.3 Q2	+3.3	501	527	8.0	6.00	5.05§
Colombia	−1.6 Jul	−4.8 Q2	−3.0	1,986	2,349	−0.2	8.31	6.08§
Mexico	−1.2 Aug	−7.0 Q2	−1.1	10.8	10.8	nil	7.20	7.84
Venezuela	+23.8 Q2	+20.4 Q2	+7.2	2,147	2,877	−2.6	11.13	6.55§
Egypt	−14.1 Q1	+3.1 Q1	+2.3	5.55	5.74	−5.5	7.29	5.52§
Israel	−9.0 Aug	+7.8 Q2	+3.4	4.03	4.27	−0.9	4.18	5.18
Saudi Arabia	+146.6 2006	+98.9 2006	+23.3	3.74	3.75	18.7	5.07	na
South Africa	−9.6 Aug	−17.4 Q2	−6.3	6.81	7.58	0.5	10.70	8.14
MORE COUNTRIES	Data for the countries below are not provided in printed editions of *The Economist*							
Estonia	−4.0 Jul	−3.1 Aug	−14.7	11.0	12.5	3.1	5.27	na
Finland	+12.5 Aug	+12.6 Aug	+6.2	0.70	0.80	4.2	4.55	4.47
Iceland	−1.9 Sep	−3.7 Q2	−16.7	60.3	68.2	3.7	13.77	na
Ireland	+36.2 Jul	−10.5 Q2	−4.9	0.70	0.80	1.1	4.66	4.45
Latvia	−7.1 Aug	−6.1 Aug	−22.2	0.50	0.56	nil	11.52	na
Lithuania	−6.5 Aug	−4.4 Aug	−14.5	2.43	2.76	−0.5	5.81	na
Luxembourg	−5.9 Jul	+4.6 Q2	na	0.70	0.80	0.3	4.66	na
New Zealand	−4.5 Aug	−9.3 Q2	−8.2	1.33	1.51	4.8	7.15	6.51
Peru	+8.6 Aug	+2.8 Q2	+1.9	3.02	3.24	0.5	5.00	na
Philippines	−3.8 Jul	+6.4 Jun	+5.2	44.2	49.9	−1.3	6.63	na
Portugal	−23.4 Jul	−17.8 Jul	−8.6	0.70	0.80	−3.2	4.66	4.60
Slovakia	−2.9 Aug	−4.2 Jun	−4.5	23.7	29.3	−2.9	4.18	4.67
Slovenia	−2.4 Aug	−1.4 Jul	−3.0	0.70	0.80	−1.2	na	na

*Merchandise trade only. †*The Economist* poll or Economist Intelligence Unit forecast. ‡Dollar-denominated bonds.

Sources: National statistics offices and central banks; Thomson Datastream; Reuters; JPMorgan; Bank Leumi le-Israel; Centre for Monitoring Indian Economy; Danske Bank; Hong Kong Monetary Authority; Standard Bank Group; UBS; Westpac.

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Markets

Oct 18th 2007
From The Economist print edition

Markets

	Index Oct 17th	% change on one week	% change on Dec 29th 2006 in local currency	% change on Dec 29th 2006 in $ terms
United States (DJIA)	13,892.5	–1.3	+11.5	+11.5
United States (S&P 500)	1,541.2	–1.4	+8.7	+8.7
United States (NAScomp)	2,792.7	–0.7	+15.6	+15.6
Japan (Nikkei 225)	16,955.3	–1.3	–1.6	+0.5
Japan (Topix)	1,600.3	–3.5	–4.8	–2.8
China (SSEA)	6,337.1	+4.6	+125.1	+133.8
China (SSEB, $ terms)	386.9	+3.5	+186.3	+197.3
Britain (FTSE 100)	6,677.7	+0.7	+7.3	+11.8
Canada (S&P TSX)	14,219.5	–0.4	+10.2	+31.5
Euro area (FTSE Euro 100)	1,404.4	+0.1	+9.8	+18.3
Euro area (DJ STOXX 50)	4,441.8	nil	+7.8	+16.1
Austria (ATX)	4,844.4	+1.0	+8.5	+16.8
Belgium (Bel 20)	4,506.4	–0.1	+2.7	+10.6
France (CAC 40)	5,818.8	–0.3	+5.0	+13.0
Germany (DAX)*	7,985.4	nil	+21.0	+30.3
Greece (Athex Comp)	5,226.6	–0.2	+18.9	+28.1
Italy (S&P/MIB)	40,259.0	–1.6	–2.8	+4.6
Netherlands (AEX)	554.6	nil	+12.0	+20.5
Spain (Madrid SE)	1,684.0	+3.5	+8.3	+16.6
Czech Republic (PX)	1,892.2	+0.6	+19.1	+28.4
Denmark (OMXCB)	483.6	–1.5	+14.0	+22.8
Hungary (BUX)	27,948.6	+0.6	+12.5	+21.4
Norway (OSEAX)	583.5	+2.8	+16.1	+33.9
Poland (WIG)	63,618.7	+1.0	+26.2	+40.3
Russia (RTS, $ terms)	2,158.1	+0.7	+6.2	+12.3
Sweden (Aff.Gen)	381.2	–3.3	+4.4	+10.7
Switzerland (SMI)	9,071.8	–1.2	+3.3	+6.7
Turkey (ISE)	57,931.9	+0.9	+48.1	+73.8
Australia (All Ord.)	6,696.1	–0.7	+18.6	+34.1
Hong Kong (Hang Seng)	29,298.7	+2.6	+46.8	+47.2
India (BSE)	18,715.8	+0.3	+35.8	+51.9
Indonesia (JSX)	2,641.6	+1.9	+46.3	+44.7
Malaysia (KLSE)	1,374.4	–0.2	+25.4	+31.0
Pakistan (KSE)	14,590.2	+0.7	+45.3	+45.9
Singapore (STI)	3,839.7	+0.7	+28.6	+34.8
South Korea (KOSPI)	1,983.9	–2.8	+38.3	+40.1
Taiwan (TWI)	9,562.2	–0.8	+22.2	+22.1
Thailand (SET)	884.5	+1.1	+30.1	+37.7
Argentina (MERV)	2,240.2	–1.6	+7.2	+4.1
Brazil (BVSP)	63,193.0	nil	+42.1	+68.0
Chile (IGPA)	15,287.0	+0.8	+23.5	+31.2
Colombia (IGBC)	10,166.3	–3.6	–8.9	+2.7
Mexico (IPC)	32,721.8	+1.8	+23.7	+23.9
Venezuela (IBC)	37,167.1	–3.1	–28.8	+10.8
Egypt (Hermes)	79,509.4	+1.2	+29.7	+33.6
Israel (TA-100)	1,157.6	+0.3	+25.6	+31.4
Saudi Arabia (Tadawul)	7,912.5	nil	–0.3	nil
South Africa (JSE AS)	31,068.3	–0.4	+24.7	+29.0
Europe (FTSEurofirst 300)	1,585.2	–0.3	+6.9	+15.0
World, dev'd (MSCI)	1,653.1	–1.0	+11.4	+11.4
Emerging markets (MSCI)	1,279.9	+0.7	+40.2	+40.2
World, all (MSCI)	419.0	–0.8	+13.9	+13.9
World bonds (Citigroup)	700.1	+0.3	+6.4	+6.4
EMBI+ (JPMorgan)	427.7	+0.3	+5.0	+5.0
Hedge funds (HFRX)	1,345.1	+0.5	+5.4	+5.4
Volatility, US (VIX)	18.5	16.7	11.6	(levels)
CDSs, Eur (iTRAXX)†	34.6	+10.4	+48.3	+59.6
CDSs, N Am (CDX)†	59.7	+13.8	+78.5	+78.5
Carbon trading (EU ETS) €‡	23.2	+4.3	+27.0	+36.8

*Total return index. †Credit-default swap spreads, basis points.

Sources: National statistics offices, central banks and stock exchanges; Thomson Datastream; Reuters; WM/Reuters; JPMorgan Chase; Bank Leumi le-Israel; CBOE; CME; Danske Bank; EEX; HKMA; Markit; Standard Bank

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Corporate taxes

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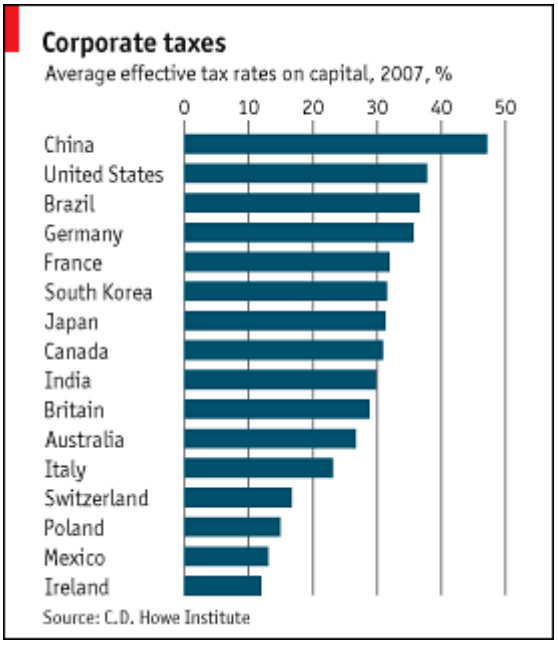
Large countries tax corporations more heavily than small countries, according to the C.D. Howe Institute, a Canadian think-tank. The institute calculates a composite measure of corporate taxes that combines taxes levied on income and investment with sales duties paid by businesses. Of the 80 countries surveyed, Argentina imposes the highest effective tax rate at nearly 48% of pre-tax profits. China and (surprisingly) America are ranked second and fourth respectively. Other large economies such as Brazil, Germany and Russia have above-average effective tax rates. Firms in Switzerland, Mexico and Ireland are lightly taxed by comparison. Singapore and Hong Kong impose taxes of less than 10% of net profits.



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